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MONTHLY

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EMERGING EQUITY MARKET UPDATE

Introduction

We have consistently included emerging market equities in our clients' individual investment policies since our firm's inception in 2004. Over the past decade, market developments including the proliferation of ETFs have made investing in emerging equity markets easier for a broad range of investors. This combined with relatively favorable media coverage and strong long-term returns have led to an increase in the number of investors who now include emerging market exposure in their portfolios. Figure 1 shows that emerging equities currently make up 13% of the global equity market, and Figure 2 shows that this weight has generally been increasing over time. Together, these figures illustrate that emerging market (EM) equities are a large and growing component of the global capital market, and should be included within a well-diversified portfolio.

In this Monthly, we review the basic characteristics of emerging equity markets and our process for valuing investments in the sector. We also provide an update on current market conditions and our forward looking return expectations.

Market Characteristics

MSCI is the leading data provider for international equity market returns. Although their precise methodology is proprietary, MSCI uses per capita income as the primary factor to categorize countries as emerg-

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Figure 1 - Composition of World Equity Market

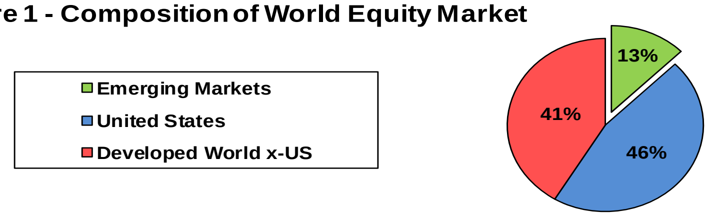
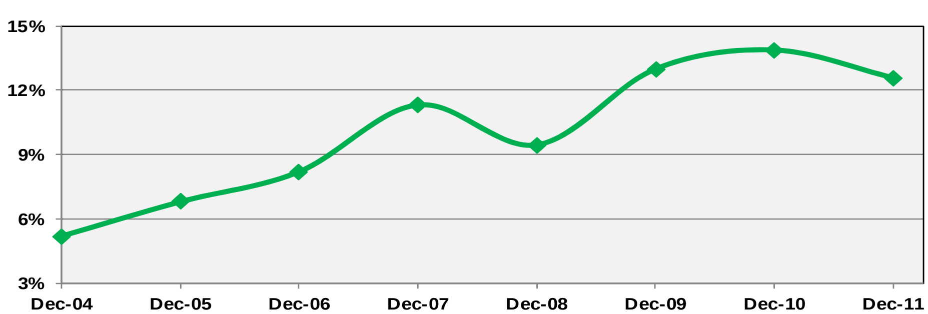


Figure 2 - Emerging Countries Share of World Equity Market



Sources: MSCI, Stairway Partners

CURRENT TOPIC

Emerging Equity Market Update

- *Introduction*
- *Market Characteristics*
- *Fundamental Valuation*
- *Expected Returns and Current Strategy*

Strategy

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

"EMERGING MARKET EQUITIES ARE A LARGE AND GROWING COMPONENT OF THE GLOBAL CAPITAL MARKET, AND SHOULD BE INCLUDED WITHIN A WELL DIVERSIFIED PORTFOLIO"

EMERGING EQUITY MARKET UPDATE - CONT'D

ing. This is consistent with the methodology used by the World Bank, a supranational institution that supplies loans to developing countries. Currently, the equities of 21 countries are included in the MSCI EM index. The table in Figure 3 lists the largest ten countries in the emerging market equity index, which account for 90% of the total market exposure. These constituents and weights will change over time due to relative market movements and net-issuance.

In the 24 years that MSCI has included emerging markets, both realized returns and risk have been materially higher than developed markets. Through the end of 2011, the MSCI Emerging Market index produced an annualized return of 12.5%. Over the same time period, the annualized return for the S&P 500 was 9.6%. As noted earlier, capturing the higher returns of emerging market equities required that investors accept a higher level of risk. The volatility of EM equities has been roughly 60% higher than that of US equities since the beginning of 1988. As a result of this higher volatility, EM equities tend to suffer more in down markets. Looking back, EM equities produced a -56.4% return during their worst 12 month period. The S&P 500's worst 12 month return within the same period was -43.5%.

Fundamental Valuation

Consistent with our methodology across all asset classes, we value EM equities based on the present value of their expected future cash flows. Like other equity investments, we believe that the future cash flows for EM equities come from dividend payments, which depend on future earnings. Unlike companies in developed markets, most of the dividends from emerging market companies do not qualify for favorable tax treatment in the United States.

Figure 3 - Top Ten Emerging Equity Markets

	Market Capitalization (as of 12/31/2011)		
	Rank	Market Value (US $'s)	% of Emerging Market Equities
China	1	577,424	18%
S Korea	2	485,820	15%
Brazil	3	483,549	15%
Taiwan	4	354,358	11%
S Africa	5	254,262	8%
Russia	6	205,095	6%
India	7	200,100	6%
Mexico	8	151,744	5%
Malaysia	9	114,960	4%
Indonesia	10	96,685	3%
Total		2,923,997	90%

Figure 4 illustrates how the earnings of companies in emerging markets have compared to those of companies in developed markets, including the United States. As was the case with market returns, corporate earnings in emerging markets grew at a faster rate and were more volatile than those in developed markets. Historically, EM earnings have grown at a trend rate of roughly 10% per annum. The trend growth rate for earnings in developed countries over the same time period was closer to 6%. We do not assume that the gap in earnings growth rates will be as large in perpetuity. This is because over time emerging economies become more developed, and the global economy continues to evolve toward more integrated manufacturing and product markets. Figure 4 also shows that EM and developed mar-

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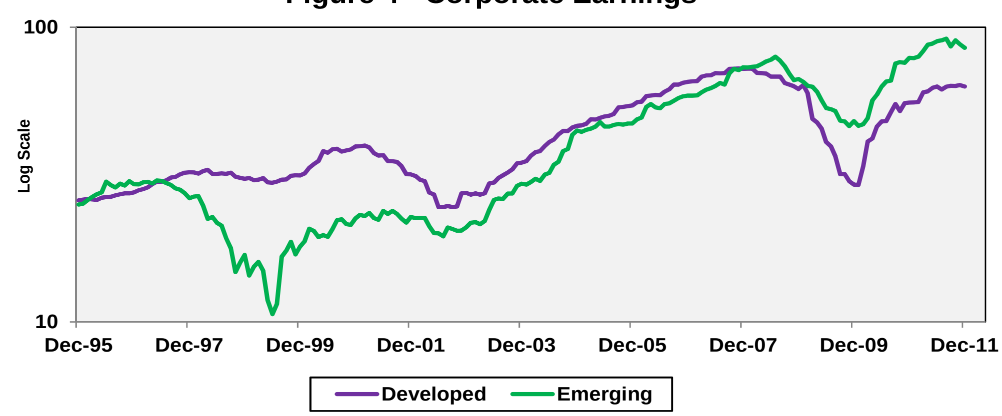
Figure 4 - Corporate Earnings



"CORPORATE EARNINGS IN EMERGING MARKETS GREW AT A FASTER RATE AND WERE MORE VOLATILE THAN THOSE IN DEVELOPED MARKETS"

Sources: MSCI, 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.

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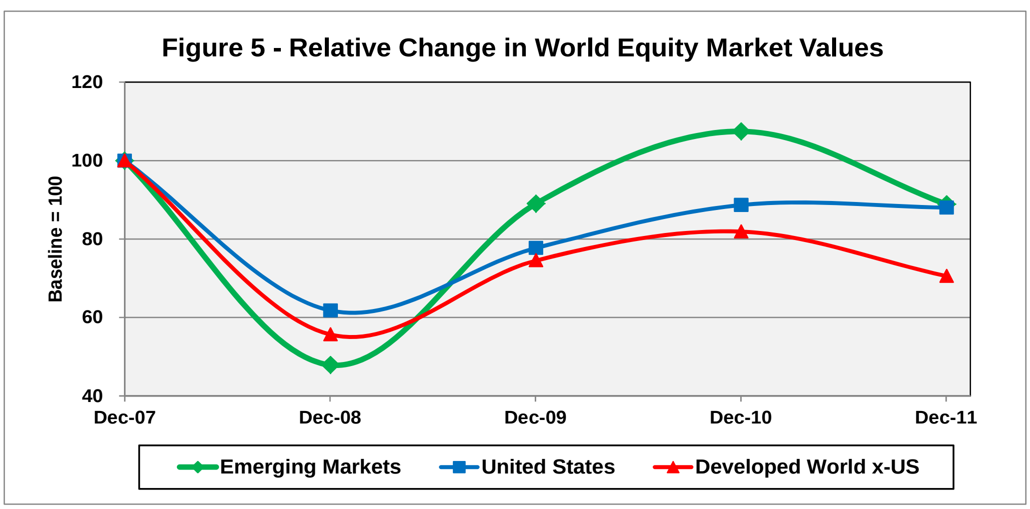
ket earnings share a positive, but far from perfect correlation. This helps to explain why EM equities provide diversification benefits within broader portfolios.

Within our valuation framework, EM dividends are discounted using a higher rate than is used for developed market dividends. The higher discount rate effectively compensates for the relative riskiness and higher cash rates within EM countries. These higher discount rates reduce the present value of future cash flows for EM equities. Using this methodology to account for the risks associated with EM equities helps us to maintain an appropriate weight within portfolios, and to avoid the temptation to increase policy exposure after periods of strong relative performance.

Expected Returns and Current Strategy

The underlying factors that drive our active strategy for emerging equity markets have evolved much like those in developed equity markets. Since the end of the most recent economic recession and financial crisis, earnings within most markets have recovered to near-trend levels, but market prices have lagged. This relationship can be observed in the P/E ratio, a widely used valuation metric. Currently, the P/E ratio for EM equities is near 12, which is well below the historical average of roughly 16. Our valuation work, which includes explicit estimates of future earnings and discount rates, yields similarly attractive results. Over a medium-term investments horizon, we estimate that EM equities will produce significantly positive returns. Our expected return estimates can be seen in the table shown on page 4.

Global equity markets tend to move in the same direction, with EM equities producing more extreme results due to their higher return volatility. 2011 was an unusual year in that there was significant divergence between EM and US equity returns. A portion of this divergence could be attributed to foreign exchange movements. Figure 5 shows the relative changes in the value of world equity markets. Because of the extreme drop in emerging equity prices in the second and third quarters of 2011 and our positive valuation estimates, we established an overweight to EM equities at the beginning of October. We believe that a continuation in the trend of positive earnings growth and a return to more normal market conditions will lead to significantly positive returns for emerging market equities.



Sources: MSCI, Stairway Partners

"2011 was an unusual year in that there was a significant divergence between emerging market and US equity returns"

3 Year Annualized Return Estimates for Global Markets

2/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**10.0%**	**4.1%**	**5.9%**	**8.5%**	**3.9%**	**4.6%**
Non-US Developed Markets	**18.5%**	**4.6%**	**13.9%**	**15.7%**	**4.4%**	**11.3%**
EMU	26.1%	4.9%	21.2%	22.2%	4.8%	17.5%
UK	24.3%	4.9%	19.4%	20.6%	4.7%	15.9%
Japan	11.2%	5.0%	6.2%	9.5%	4.8%	4.7%
Canada	-4.6%	4.3%	-9.0%	-3.9%	4.2%	-8.1%
Emerging Markets	**16.8%**	**5.8%**	**11.0%**	**13.6%**	**5.6%**	**8.0%**
Fixed Income						
US Aggregate	**-1.5%**	**2.1%**	**-3.6%**	**-1.9%**	**1.9%**	**-3.8%**
US Treasuries						
2 Year	-0.3%	0.9%	-1.2%	-0.7%	0.7%	-1.3%
5 Year	-3.5%	1.4%	-4.9%	-3.4%	1.2%	-4.6%
10 Year	-6.4%	1.9%	-8.3%	-5.9%	1.7%	-7.6%
30 Year	-9.1%	2.1%	-11.1%	-8.1%	1.9%	-10.0%
TIPS						
5 Year	-2.6%	1.4%	-4.1%	-2.7%	1.2%	-4.0%
10 Year	-6.2%	2.0%	-8.2%	-5.7%	1.8%	-7.5%
30 Year	-13.9%	2.4%	-16.2%	-11.9%	2.2%	-14.1%
Municipal	**-0.9%**	**1.5%**	**-2.4%**	**-0.3%**	**1.3%**	**-1.6%**
2 Year	0.0%	0.8%	-0.8%	0.3%	0.6%	-0.3%
5 Year	-1.9%	1.1%	-3.0%	-1.2%	1.0%	-2.2%
10 Year	-2.6%	1.6%	-4.2%	-1.7%	1.4%	-3.1%
20 Year	0.0%	1.8%	-1.9%	0.6%	1.6%	-1.1%
High Yield	**2.7%**	**3.0%**	**-0.3%**	**0.9%**	**2.8%**	**-1.9%**
High Quality High Yield	2.5%	2.2%	0.3%	0.8%	2.0%	-1.2%
Emerging Market ($ demonimnated)	**0.1%**	**3.3%**	**-3.1%**	**-1.0%**	**3.1%**	**-4.1%**
Foreign Aggregate	**-4.9%**	**3.5%**	**-8.4%**	**-4.5%**	**3.3%**	**-7.8%**
Foreign Aggregate (hedged)	-2.9%	1.8%	-4.7%	-3.3%	1.6%	-4.9%
Foreign Treasury	**-5.2%**	**3.1%**	**-8.2%**	**-4.7%**	**2.9%**	**-7.6%**
Foreign Treasury (hedged)	-3.3%	1.4%	-4.7%	-3.6%	1.2%	-4.8%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-3.2%	2.3%	-5.5%			
British Pound	-1.1%	2.2%	-3.3%			
Japanese Yen	-1.2%	2.4%	-3.6%			
Canadian Dollar	-1.8%	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)