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EMERGING EQUITIES - A PERSPECTIVE

Introduction

Emerging equities, shares of companies traded on exchanges in emerging countries, generally have higher growth rates, higher returns and higher risk than other asset classes. Over the last three years, emerging equities have outperformed all other major equity indices (Figure 1) which in turn has led to more interest in the sector. The purpose of this article is to bring perspective and provide context as to how this sector should be incorporated into one's investment discipline.

Background

The most widely followed benchmark for emerging equities is the Morgan Stanley Capital International (MSCI) Emerging Markets Index. This market capitalization weighted index is designed to measure the performance of emerging equity markets. Although the index returns are reported in US dollars, investors are exposed to currency risk from the countries that make up the index.

The inclusion of a stock market in the MSCI Emerging Markets Index is primarily driven by the gross net income per capita threshold used by the World Bank to categorize countries. Other economic and equity market factors are also considered by MSCI, but are secondary in nature. As of December 31, 2004, the MSCI Emerging Markets Index comprised 26 countries (Figure 2), 731 securities in 10 industry groups with a market capitalization of 1.12 trillion US dollars. Emerging equities comprise approximately 2.3% of what Stairway Partners considers to be the global investable capital market of stocks and bonds. They also represent 4.5% of the investable global equity market.

Investment Objectives

The inclusion of a specific asset class in the construction of one's financial blueprint must be evaluated within the context of long-term investment goals. Essential elements that need to be considered for each asset class are risk, return and correlation.

Risk can simply be described as how variable returns can be. Correlation is the manner in which an asset class moves in concert with other asset classes. Asset classes

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CURRENT TOPICS

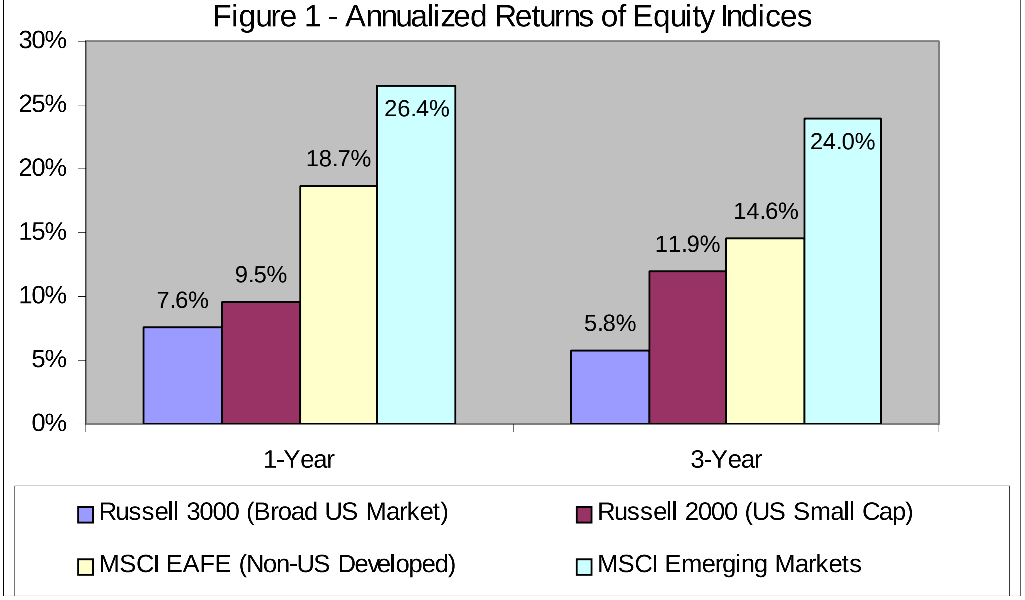
Emerging Equities

- *Background*
- *Investment Objectives*
- *Valuation*
- *Investment Implications*

Expected Returns & Strategies

- *High Yield & Emerging Debt increase their overvaluation*
- *Investment Grade Bonds slightly less overvalued*
- *Non-US Equity Markets moved higher but still reasonably priced*

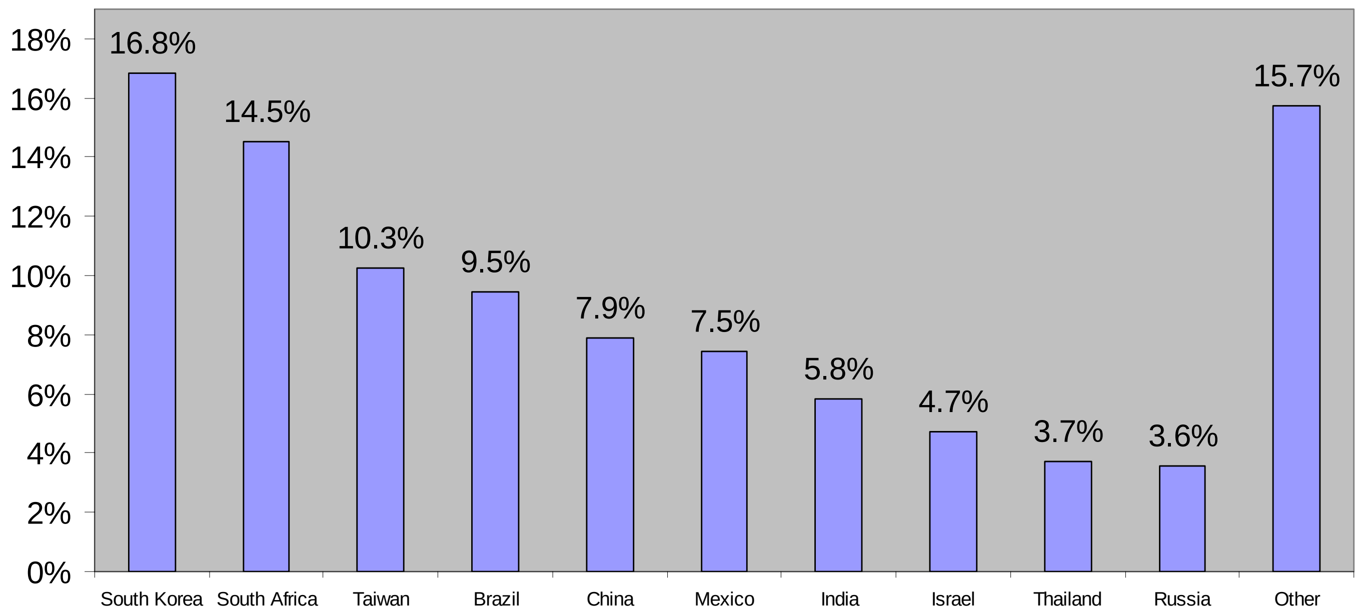
Figure 1 - Annualized Returns of Equity Indices



Source: MSCI, Russell, Stairway Partners, LLC Returns as of 2/28/2005

EMERGING EQUITIES - CONTINUED

Figure 2 - Emerging Markets Country Weights (12/31/2004)



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that have a correlation of less than one can provide superior risk-return characteristics when used in combination. Figure 3 illustrates this point by combining US equities with small amounts of emerging equities, assuming a correlation of 0.65. The range of weightings in diversified blueprints may start at 2% in a low-risk blueprint and rise to 10% or more in a high-risk blueprint.

Figures 4 and 5 illustrate how emerging equity risk and correlation compare to the US broad equity market over time. Over the last five years, observed risk in emerging equities has declined toward US risk. Simultaneously, the correlation between emerging and US equities has moved higher. This may be attributed to increased acceptance of emerging equity markets and the integration of the asset class into conventional portfolios.

It is important when devising a financial blueprint to incorporate the long-term risk and correlation assumptions. Shorter-term developments will affect strategy decisions rather than the blueprint.

Valuation

As part of our process, Stairway Partners links risk with return when making investment decisions. An investor needs to be compensated for the risk inherent in an investment; therefore, we quantify the hurdle return that is necessary as compensation.

Our estimate of the hurdle return for emerging equities, given their high risk, is 12.4%. Simply put, emerging equities should return 12.4% on an annualized basis to properly cover the associated risk. The next step is to measure the fundamental cash flows that accrue from emerging equities which primarily come from growth rates, earnings and dividends. Cash flows are then discounted by the hurdle rate to objectively gauge a fair value for the asset class. A comparison of current market pricing to this fair value provides us with an expected return.

Investment Implications

Our expected return from emerging equities is approximately 7.3% per annum over

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Figure 3 - Combining Asset Classes

	US Equity	Emerging Equity	90/10 Blend US/Emerging Equity	
Return	7.1%	12.4%	% of US Equity Return	107%
Risk	15.0%	25.0%	% of US Equity Risk	102%

Note: These estimates are based on Stairway Partners LLC long-term risk and hurdle return assumptions.

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. 90% 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.

STAIRWAY PARTNERS, LLC IS EXPERIENCING SIGNIFICANT GROWTH IN CLIENTS AND ASSETS IN ADDITION TO INTEREST IN OUR RESEARCH. THANKS FOR ALL YOUR SUPPORT.

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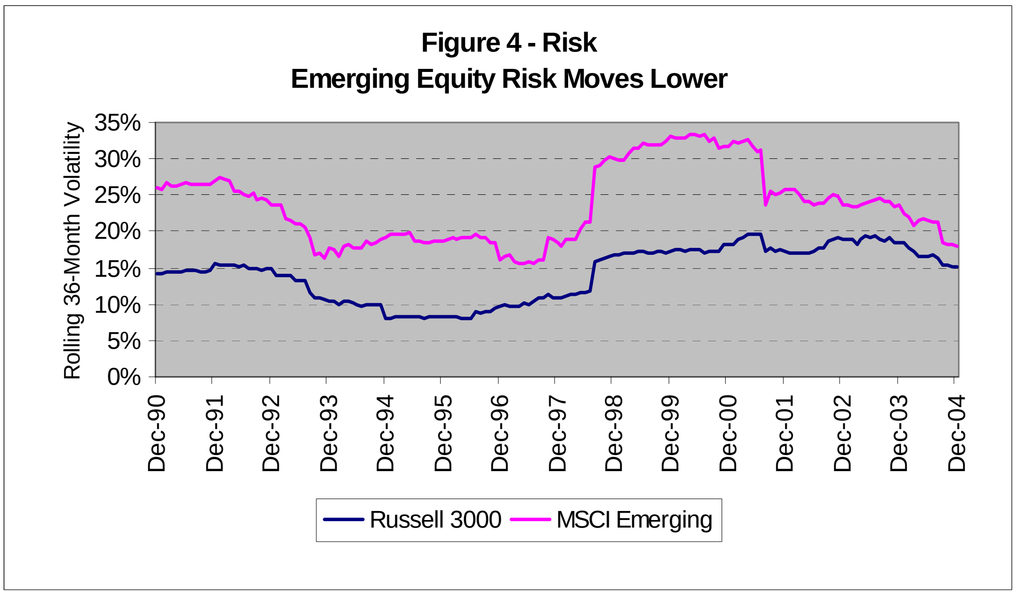
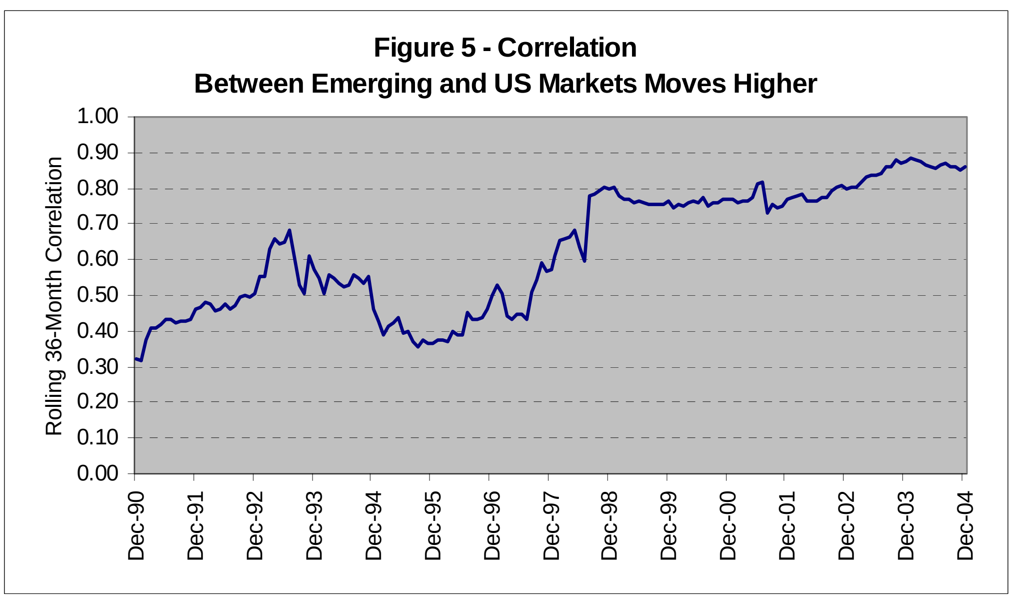
the next three years. This rate of return, which is less than our hurdle return of 12.4%, leaves the asset class slightly overvalued. We currently maintain a neutral weight in emerging equities but look to reduce allocations if the pace of outperformance continues. Year-to-date, emerging equities have been the best performer with a return of 9.0% versus -0.5% for US equities.

Summary

Emerging equities, as part of the global opportunity set, should be incorporated into one's long-term blueprint. Emerging equities have higher risks and returns than other conventional asset classes. Stairway Partners analyzes each client's long term objectives to set the appropriate amount of emerging equities for their blueprint. Lastly, our valuation process ensures that each client's emerging equity exposure considers both the risk and opportunity of the asset class.





Source: MSCI, Russell, Stairway Partners, LLC

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.0%	7.1%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				
Eurozone	6.0%	6.7%	neutral	Close to fair value
Japan	0.1%	4.3%	neutral	Volatile fundamentals; recovery has stalled
UK	8.9%	8.4%	neutral	Pound strength may undermine attractive price
Emerging	7.3%	12.4%	neutral	Continuing strength has made asset class less attractive
Fixed Income				
US Treasury Bonds			under	Real rates are too low, but pricing has improved
2-Year	3.5%	4.1%		
5-Year	3.6%	4.5%		
10-Year	3.4%	4.8%		
25-Year	3.2%	5.1%		
US Municipal Bonds			neutral	Attractiveness in longer maturities
2-Year	2.5%	2.9%		
5-Year	2.8%	3.3%		
10-Year	3.5%	3.7%		
25-Year	6.3%	4.3%		
US High Yield	3.1%	5.6%	under	Too much risk for the yield
Emerging Markets Debt	3.9%	5.8%	under	Too much risk for the yield
Cash	3.6%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected Return	Equity Return with Currency
Euro	-4.0%	2.0%
Japanese yen	1.5%	1.6%
UK pound	-5.0%	3.8%

Notes: **As of: 2/28/2005**

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.