STAIRWAY PARTNERS, LLC

2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

MONTHLY

VOLUME 7, ISSUE 4 APRIL 2010

EARNINGS AND EQUITY VALUATION

Introduction

March 9th was the one year anniversary of the equity market bottom. Although the market rally of the last twelve months has corresponded to a recovery in the broad US economy, many have been surprised by its magnitude. This is because some statistics, like the unemployment rate, have not shown significant improvement. Although current economic conditions are relevant to fundamental investment analysis, we believe that they need to be viewed within the context of how they will evolve and impact longer term corporate earnings.

As one might expect, the recovery in the US economy over the past several quarters has led to an improvement in corporate earnings. This improvement has far exceeded expectations and has been nearly as dramatic as the decline that preceded it.

In this *Monthly* we will examine the role that corporate earnings play in our equity valuation process, and review the current state of earnings relative to our forward looking expectations.

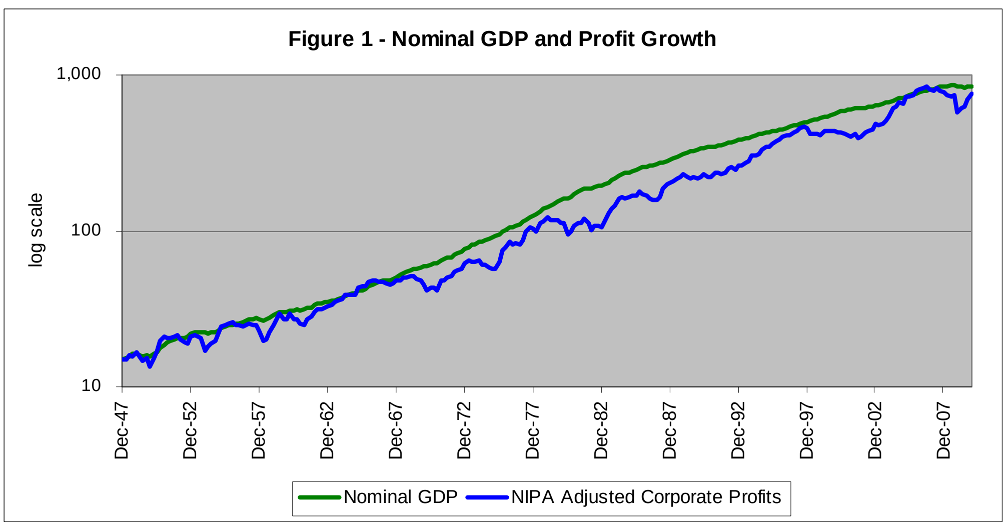
Earnings Drive Returns

Markets can be extremely volatile and predicting what factor or event will cause short-term movements is extremely difficult. However, over longer time periods, equity prices generally follow a path that is determined by the value of the earnings that businesses produce. This is a fundamental view that is widely accepted for individual companies. In the words of Warren Buffet, "If a business does well, the stock eventually follows." The theory that equity values follow earnings is also supported by broader fundamental research. McKinsey & Company studied valuations for US and international companies between 1962 and 2003 and found a strong relationship between

(Continued on page 2)

Strategy

- *There were no strategy changes during the month of March*
- *Portfolio strategies remain overweight developed equity markets*



Source: US Bureau of Labor Statistics

"US GROSS DOMESTIC PRODUCT AND CORPORATE PROFITS HAVE BOTH GROWN OVER TIME AT A SIMILAR RATE"

Earnings and Equity Valuation - Cont'd

market prices and fundamental value based on corporate earnings.

We believe that long-term equity market returns are a function of aggregate corporate profits. As a result, our expected equity market returns are derived from forward looking earnings estimates which are in turn based on long-term forecasts of real economic growth and inflation. This relationship can be seen in Figure 1, which shows that Nominal US gross domestic product (GDP) and corporate profits have both grown over time at a similar rate. This figure also illustrates that corporate profits tend to be cyclical and are considerably more volatile than GDP.

Observing Earnings

Governments track corporate earnings through tax receipts and data service companies also provide aggregated corporate earnings data with differing levels of timeliness and transparency.

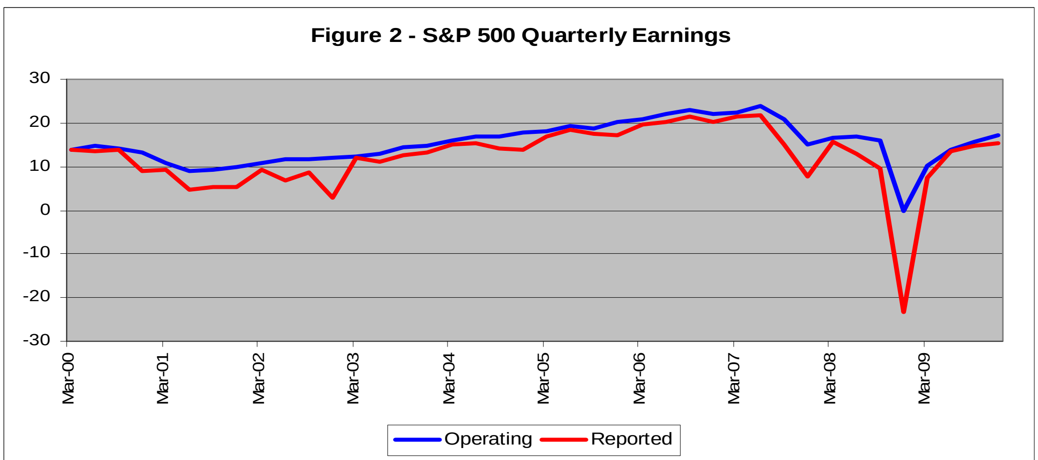
Since indices that cover a given market tend to be highly correlated, data compiled for one index can often serve as an effective proxy for a different index covering the same market. For example, we use the S&P 500 to analyze the US equity market. This is because Standard and Poor's provides very transparent and timely reporting of corporate earnings for the companies in the S&P 500 index, which makes it an excellent barometer for the overall profitability of US corporations.

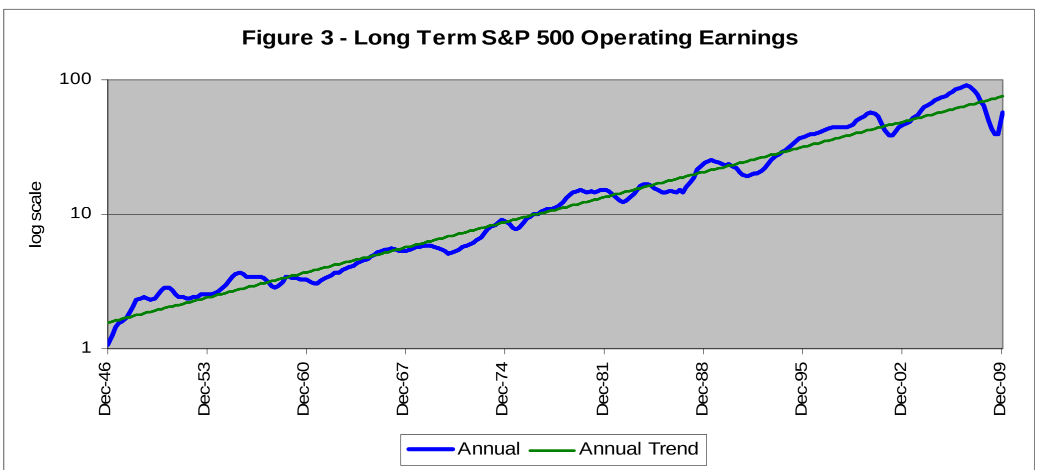
Cyclicality and Earnings Volatility

Like equity market returns, earnings are very volatile and difficult to predict in the short-term. This was especially true over the past several years as both reported and operating earnings experienced unprecedented declines, as can be seen in Figure 2. Earnings volatility can impair the usefulness of valuation metrics like price/earnings ratios, which tend to emphasize short-term earnings. As we have written about extensively in past *Monthlies*, we believe that acting on short-term indicators often leads to poor long-term results. John Bogle, the founder of the Vanguard Group and a vocal proponent of long-term investing, shares our opinion and gives this advice to investors; "Time is your friend; impulse is your enemy." Figure 3 illustrates that a long-term perspective is valuable, as earnings tend to follow a cyclical pattern around a relatively stable trend.

As stated earlier, Stairway's valuation methodology for equities is based on long-term corporate earnings estimates, which are consistent with broad economic activity. This perspective allows us to look through volatility in

(Continued on page 3)





Sources: Standard & Poor's, Stairway Partners

"A LONG-TERM PERSPECTIVE IS VALUABLE, AS EARNINGS TEND TO FOLLOW A CYCLICAL PATTERN AROUND A RELATIVELY STABLE TREND"

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.

(Continued from page 2)

near-term earnings and produce more stable long-term expected return estimates.

Current Environment

US corporations cut costs dramatically in 2008 and 2009. These cost savings resulted in a dramatic bounce in earnings as the economy returned to positive growth in the second half of 2009. We believe that this rapid recovery provides evidence that the long-term trend in earnings has not been broken. Looking back at Figure 3, one can see that the high level of earnings that the market embraced in 2007 was above what we believed to be the sustainable trend. The subsequent plunge, which brought operating earnings for the S&P 500 below zero for the first time in the history of the series, has turned out to be equally unsustainable. In fact, current analyst estimates bring S&P 500 operating earnings back to our estimate of its long-term trend by the end of this Summer.

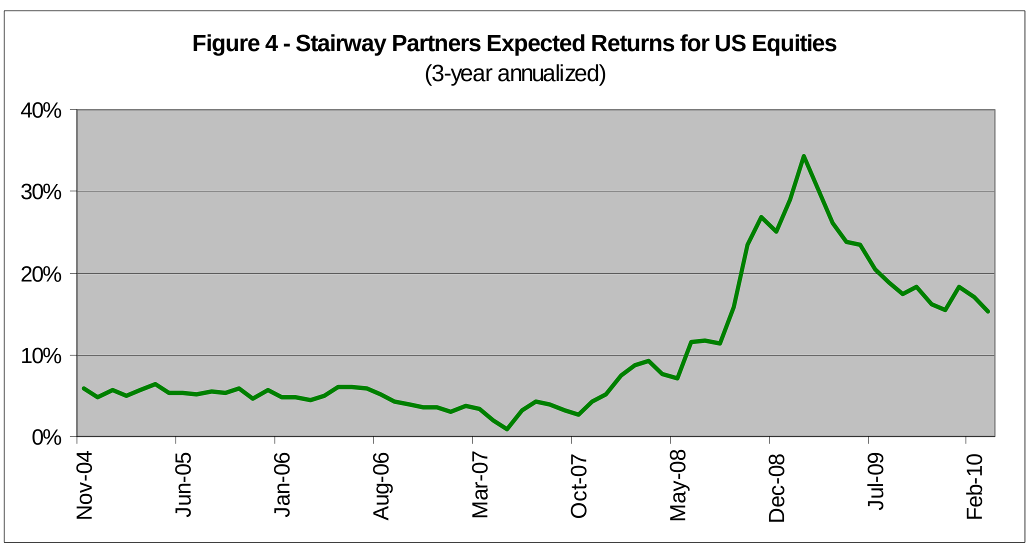
Our valuation process indicates that US equity prices, although they have appreciated substantially, do not fully reflect the earning potential of US companies. Figure 4 shows the history of our expected returns for US equities. The graph illustrates that US equities, as a result of their recent price appreciation, are not nearly as attractive as they were a year ago. However, that the asset class still offers attractive prospective returns. The graph also shows that the substantial returns that US equity investors enjoyed over the past twelve months were warranted, based on our valuation estimates from the beginning of 2009. It is important to remember that our expected returns are estimated over a three-year time horizon, and are not meant to predict short-term market movements.

Conclusion

As long-term fundamental investors, we believe that equity market returns ultimately reflect corporate earning potential. Although the volatility of the past several years has been extreme, the recent recovery in earnings leaves the long-term trend that we use in our equity valuation process largely intact.

The equity market rally of the last twelve months has produced excellent returns, and as a consequence has reduced prospective returns that are available to investors. However, our valuation process, which is based on long-term earnings estimates, indicates that there is still reasonable value in the US equity market.

"THE SUBSTANTIAL RETURNS THAT US EQUITY INVESTORS ENJOYED OVER THE PAST TWELVE MONTHS WERE WARRANTED, BASED ON OUR VALUATION ESTIMATES FROM THE BEGINNING OF 2009"



Source: Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	14.9%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive
Eurozone	19.7%	5.8%		
Japan	12.3%	4.4%		
UK	14.5%	6.1%		
Emerging	2.2%	10.3%	neutral	Asset class slightly above fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.8%	2.8%		
5-Year	1.1%	3.7%		
10-Year	1.9%	4.5%		
30-Year	2.5%	5.0%		
US Municipal Bonds			under	In most maturities, municipal bonds are overpriced
2-Year	0.7%	2.1%		
5-Year	1.0%	2.7%		
10-Year	2.1%	3.4%		
30-Year	6.4%	4.2%		
US High Yield	3.0%	4.3%	over	Sector is close to fair, but attractive relative to other fixed income
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	0.8%	4.0%		
Japan 10-Year	-0.2%	1.9%		
UK 10-Year	1.9%	4.7%		
Emerging Markets Debt	2.2%	4.6%	under	Other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.2%	14.5%	-4.4%	Euro is moderately overvalued
Japanese yen	-0.7%	11.6%	-1.0%	Yen is near fair value
UK pound	0.4%	14.9%	2.3%	Pound is near fair value

Notes: **As of: March 31, 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.