STAIRWAY PARTNERS, LLC

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

MONTHLY

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EXPENSES MATTER

Introduction

An important issue in managing your wealth is how much of your gains you keep after accounting for all expenses. A good return on your investments is great, but often people are not fully aware of the impact fees and taxes have on their portfolios.

In this *Monthly,* we will explore the impact of expenses and how we do our part in keeping them low, ensuring that more of our clients' money remains in their own pockets.

Expenses come in a variety of forms. Some are obvious, such as explicit management fees. Others show up outside a client's portfolio, such as taxes on income and realized capital gains. In this *Monthly*, we will examine a number of these expenses, utilizing simple comparisons to highlight their corrosive effects.

Management Fees

Many investment advisors and wealth managers charge fees for the management of a client's portfolio. These fees are typically stated as an annual percentage of the assets under management. The net, or after-fee, performance of the portfolio will differ from the gross performance by the amount of the management fees.

According to Morningstar, the average annualized expense ratio for mutual funds that fall under the category of Moderate Allocation is 1.41%. Moderate Allocation is reflective of diversified portfolios, inclusive of stocks and bonds, with moderate risk. Managed accounts and wrap accounts often have fees that are even higher.

As a comparison, the highest management fee our clients incur for a separately managed customized portfolio is 0.75%. This fee declines as the assets under management increase. This is 0.66% lower than the average Moderate Allocation

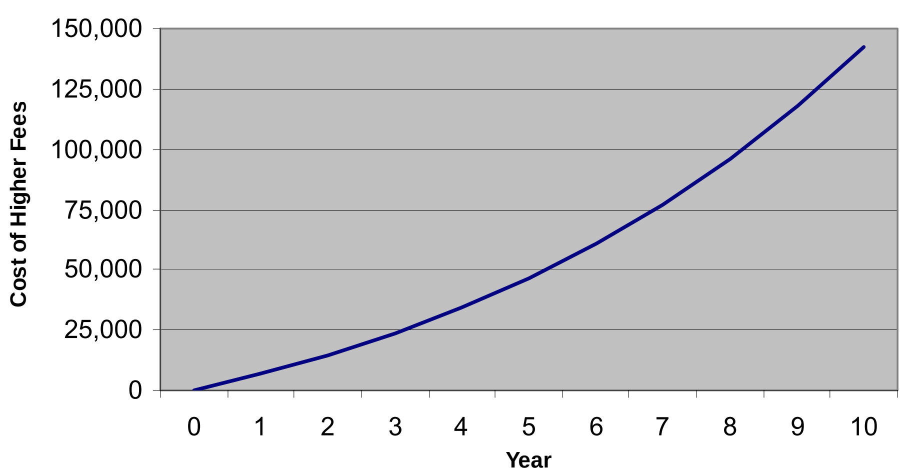
(Continued on page 2)

CURRENT TOPICS

STRATEGY

Due to the strength in the equity market, we have conducted several portfolio rebalancings. To get back to strategy weights, we reduced exposure to non-US developed equity markets and added to high-quality bonds.

Figure 1: The Effect of Management Fees



"WITH COMPOUNDING AND TIME, THE DIFFERENCE BETWEEN THE TWO PORTFOLIOS BECOMES SIGNIFICANT: $142,417 ON A MILLION DOLLAR INITIAL INVESTMENT BY YEAR 10"

EXPENSES MATTER - CONT'D

mutual fund.

In Figure 1, we show a simple comparison of what the effect of this management fee difference would be on two $1 million portfolios that delivered a 10% return each year before fees. The 0.66% difference equates to a difference of $6,600 in year one. But as you can see in the graph, with compounding and time, the difference between the two portfolios becomes significant: $142,417 on a million dollar initial investment by year 10.

Taxes

In addition to management fees, taxes determine what investors end up keeping in their own pockets. Tax effects do not show up in the portfolio itself or in standard performance measures the way that other fees do. As a result, most investors either are not aware of their managers' performance adjusted for taxes, or have only a vague idea when they write a check to the government. In the examination of the effect of taxes on portfolio returns, several factors arise.

◦ Bond exposure

The use of taxable bonds in a taxable account can add considerable cost. Since our portfolios are separately managed, we incorporate municipal bonds in client accounts that are exposed to high marginal tax rates.

Since municipal bond yields are tax-advantaged, a municipal bond has a lower yield than a Treasury bond. This difference in yield should be reflective of the tax liability and the differences in risk between the two bonds. Given the very high credit quality of both bonds, we believe the municipal bond is more attractive to investors that are in the highest marginal tax bracket. Figure 2 shows that the tax advantage of holding a 10-year AAA municipal bond instead of a 10-year Treasury bond is 0.80% per annum.

Figure 2: 10-Year Bond Comparison

	US Treasury	AAA Municipal
Yield	4.62%	3.80%
Tax @ 35%	-1.62%	-
After-Tax Yield	3.00%	3.80%

Sources: Bloomberg, Stairway Partners As of 4/30/2007

Figure 3: Tax Implications of Turnover

Equity portfolio value	600,000
Amount of portfolio turnover at 50%	300,000
Proceeds from turnover	300,000
Assumed cost basis	250,000
Gains	50,000
Assumed short-term gains (35% marginal tax rate)	25,000
Assumed long-term gains (15% tax rate LT gains)	25,000
Taxes due on gains	
short-term	8,750
long-term	3,750
Reduction in return performance	
from short-term gain	-1.46%
from long-term gain	-0.63%
Total reduction in return performance	-2.08%
Total tax impact on return for 60% of portfolio	-1.25%

◦ Portfolio Turnover

There is no notion of tax-advantaged "classes" of stocks as there are for bonds. Instead, adverse tax consequences in equity portfolios can arise from turnover – i.e., the realization of taxable capital gains. Figure 3 sets out an exposition of how capital gains taxes might affect returns in an equity portfolio.

In this example, we have assumed that the manager of the equity portion of the $1 million portfolio trades moderately, with a 50% turnover. This 50% turnover ratio means that, on average, half of the portfolio is "new" every year. In reality, many active equity managers have turnover well in excess of 50%, which implies not only that trading is much more frequent than in our example, but also that the stocks are typically held for much shorter periods of time. As a result, we feel our example is conservative in assessing the negative tax implications.

"ASSUMING A DIVERSIFIED PORTFOLIO . . . THE FINAL TAX IMPACT RESULTS IN A 1.25% REDUCTION TO THE OVERALL AFTER-TAX PORTFOLIO RETURN"

Using the 50% turnover number and an equity portfolio of $600,000 tells us that $300,000 of stocks were bought and sold during the year. If we assume that the cost basis of that $300,000 was $250,000 (implying appreciation of 20%), the gains realized would be $50,000. If half of the gain was short-term and half long-term, the capital gains tax liability would be $12,500 – just over 2% of the equity portfolio value. In this example, in a $1 million diversified portfolio that has 60% equities, the tax liability reduces the investor's return by 1.25%. At higher portfolio turnover rates, the tax consequences only get worst.

Combining it all

We can quantify the long-term effect of combining the costs discussed in this

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.

Figure 4: Combining it All

	Avg. Expense	Low Expense
Pre-expense Return	10.00%	9.67%
Less:		
Management Fees	-1.41%	-0.75%
Tax Impact of Bonds	-0.65%	-
Tax Impact of Equities	-1.25%	-0.25%
Post-expense Return	6.69%	8.67%

Monthly by comparing two hypothetical portfolios and observing the difference in value over 10 years. The first portfolio, which we call Average Expense, assumes the higher expense ratio of 1.41%, the use of taxable bonds, and 50% equity portfolio turnover. The second portfolio, which we call Low Expense, has a lower management fee of 0.75%, uses municipal bonds, and has only 10% equity portfolio turnover.

Both portfolios start with $1 million. The Average Expense portfolio has a pre-expense return of 10% while the Low Expense portfolio has a smaller pre-expense return of 9.67% to account for the use of lower yielding municipal bonds. As shown in Figure 4, the aggregate effect of the combined costs on the Average Expense portfolio results in an annual post-expense return of 6.69%. The Low Expense portfolio has a significantly higher post-expense return of 8.67%.

In Figure 5, we use the same approach as in Figure 1 to show the effect of this 1.98% difference in annualized post-expense return. With compounding and time, the portfolio difference is even more significant than Figure 1: $385,190 on a million dollar initial investment by year 10.

Stairway Difference

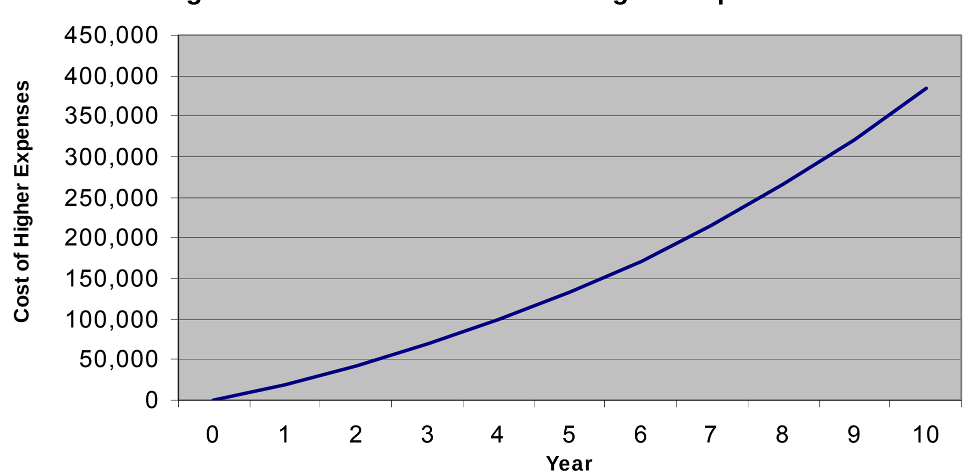
At Stairway Partners, our clients have a full accounting of performance which includes the breakout of our management fees. In addition, we produce reports that show the effect of taxes on returns.

We are sensitive to the impact that all costs have on performance. In managing portfolios, we pay attention to the impact strategy changes have on turnover and capital gains realization. Bond exposures are appropriate for each portfolio's tax situation. Finally, our management fees are well below much of the wealth management industry.

Conclusion

Expenses matter greatly in regards to what investors keep from the returns they earn during the year. Investors need to account for all the expenses that may reduce their return. These include not only management fees, but tax considerations as well. As these simple examples demonstrate, your portfolio returns can be eroded by a sizeable amount.

Figure 5: The Effect of Combining All Expenses



"WITH COMPOUNDING AND TIME, THE COMBINED EXPENSES ARE EVEN MORE SIGNIFICANT THAN FIGURE 1: $385,190 ON A MILLION DOLLAR INITIAL INVESTMENT"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	2.0%	8.5%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	-3.4%	7.6%		
Japan	-10.2%	4.6%		
UK	2.9%	8.7%		
Emerging	-4.1%	10.8%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.6%	4.6%		
5-Year	4.4%	4.7%		
10-Year	4.0%	4.9%		
30-Year	3.5%	5.2%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.6%	3.4%		
5-Year	3.7%	3.6%		
10-Year	3.9%	3.8%		
30-Year	6.1%	4.2%		
US High Yield	3.7%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	3.3%	4.6%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	4.6%	5.3%		
Emerging Markets Debt	3.3%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.6%	-8.9%	-2.3%	Euro is somewhat expensive
Japanese yen	6.0%	-4.2%	6.4%	Yen is slightly attractive
UK pound	-6.5%	-3.6%	-1.9%	Pound is somewhat expensive

Notes: **As of: April 30, 2007**

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.