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MONTHLY

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TAXES AND INVESTMENT RETURNS

Introduction

The budgetary effects of fiscal stimulus and long-term entitlements have left the US federal government in a position where spending will need to be reduced and revenues will need to be increased to avoid a spiraling federal debt problem. Unfortunately, this situation will almost certainly result in increased taxes for those in the highest income tax brackets.

Investors are justifiably concerned about how potential tax changes will affect their investment returns in the coming years. In this *Monthly* we will provide some perspective on potential US income tax changes and their likely impact on investment returns.

US Tax Rates

In 2003, President Bush approved temporary tax cuts which will remain in effect through the end of this year. If no new legislation is passed and these temporary reductions are allowed to expire, investors in the highest tax bracket will be affected in several ways. First and foremost, the highest marginal tax rate would increase from 35% to 39.6%. Secondly, dividends paid to investors would no longer be taxed at 15%, and would increase to the aforementioned 39.6% rate that would be apply to ordinary income. Finally, the tax rate on long-term capital gains would increase from 15% to 20%.

Figure 1 shows how the higher marginal income tax rate would compare to long-term history and the post-World War II average. The graph illustrates that the potential increase is modest and leaves the highest marginal tax rate relatively low by historical standards. We recognize that tax policy is complicated and the highest marginal tax rate doesn't fully explain the tax burden of wealthy individuals. However, it does provide

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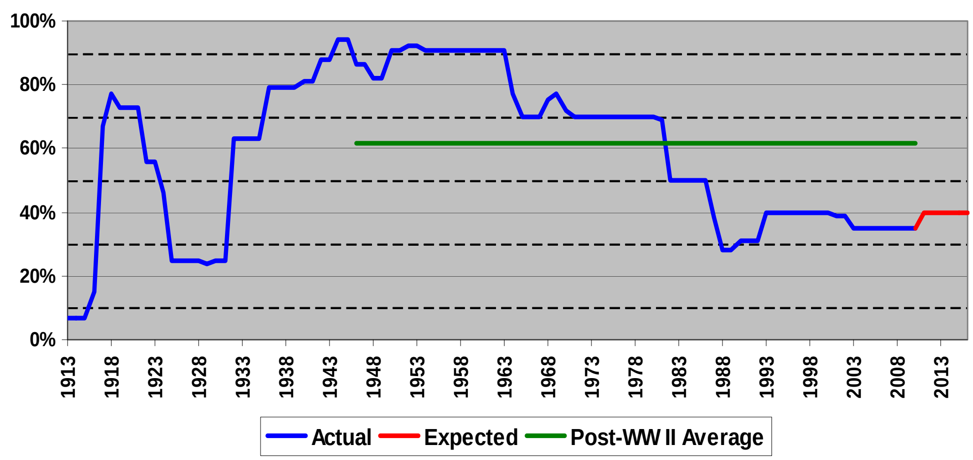
CURRENT TOPIC

STRATEGY

- *As a result of strong performance in the US equity market, we reduced our overweight to this asset class*
- *Portfolio strategies remain overweight developed equity markets*

Figure 1 - Top Marginal Personal Income Tax Rate



Sources: Tax Policy Center: Urban Institute and Brookings Institution, Stairway Partners

"THE POTENTIAL INCREASE IS MODEST AND LEAVES THE HIGHEST MARGINAL TAX RATE RELATIVELY LOW BY HISTORICAL STANDARDS"

Taxes and Investment Returns - Cont'd

some context for current tax policy and puts the magnitude of likely changes into perspective.

Because there are aspects of the temporary tax cuts that neither political party want to see eliminated, it is very likely that the Bush tax cuts will not just be allowed to expire. As a result, we believe that the most likely outcome is that President Obama's current tax proposal will be enacted. This proposal, which was originally part of his campaign platform, includes the following provisions.

- 20% tax rate on long-term capital gains
- 20% tax rate on qualified dividends
- 39.6% marginal tax rate on top income bracket

In addition to these pending changes, as a part of health care reform, in 2013 a 3.8% Medicare tax will be placed on all investment income including dividends and capital gains for top income earners. Figure 2 shows the total effect of these pending and proposed tax changes. The estimated future rates will serve as the basis for our analysis of after-tax returns.

Taxes and Market Returns

Higher taxes have the effect of reducing returns for the investors who pay them. As a result, it seems as though increasing taxes would reduce the supply of capital available to businesses, negatively impacting the stock market and the overall economy. Surprisingly, over the past 60 years there has been no meaningful relationship between the highest marginal tax rate and market returns, corporate profitability or economic growth. The correlations for all three variables relative to the highest marginal tax rate have been close to zero. Even if a lag is introduced to reflect the market's ability to anticipate tax changes, there is no material improvement in the relationship. These results can be confirmed anecdotally. Looking back, we can observe periods where marginal tax rates were relatively high but markets produced positive returns and economic growth was robust. More recently, low marginal tax rates preceded the largest recession and market decline since the Great Depression.

We are not taking the position that higher taxes are good for markets or the economy. Rather, we are making an observation that historically other factors have overwhelmed tax policies and made their effects on broad economic and market performance difficult to quantify.

A possible explanation for the lack of correlation is that the majority of US equity investors are not subject to US personal income taxes. More than two thirds of the US equity market is held by qualified retirement plans, offshore investors, charitable foundations or endowments. Demand from these investors would likely increase if taxable investors were to reduce allocations and drive down prices. Another possible explanation is that that the return premium for equities may be sufficiently large to allow for higher taxes to exist without causing a mass exodus from the asset class. The higher expected returns for equities can be seen in Figure 3, which contains our long-term return estimates. The assumptions behind these estimates are calibrated using economic and market data which reflect many different tax regimes, going back through the end of World War II.

After-Tax Returns

Taxes do have a meaningful impact on returns for the investors who pay them. As a result, it is important to take taxes into account when constructing portfolios for taxable investors. Figures 3 and 4 show our long-term after-tax return assumptions for US assets.

When we apply our estimated future tax rates, the expected after-tax returns decline for all asset classes, with the exception of municipal bonds. Although the af-

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Figure 2 - Top Bracket Marginal Tax Rates

	Investment Income	Qualified Dividend Income	Long-Term Capital Gains
Current	**35.0%**	**15.0%**	**15.0%**
+ Medicare Tax	3.8%	3.8%	3.8%
+ Proposed Increase	4.6%	5.0%	5.0%
Estimated Future	**43.4%**	**23.8%**	**23.8%**

Source: Stairway Partners

"As part of health care reform, in 2013 a 3.8% Medicare tax will be placed on all investment income including dividends and capital gains"

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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ter-tax return on equities has the largest decline, the asset class still produces the highest expected long-term return. This is mostly attributable to equities higher before-tax return characteristics, but it is also the result of the remaining favorable treatment of dividends and long-term capital gains.

It is important to note that investor behavior plays a role in realizing the tax benefits of long-term capital gains. A portfolio with high turn-over will be more likely to generate short-term gains, which are taxed at the same higher rate as interest income.

Conclusion

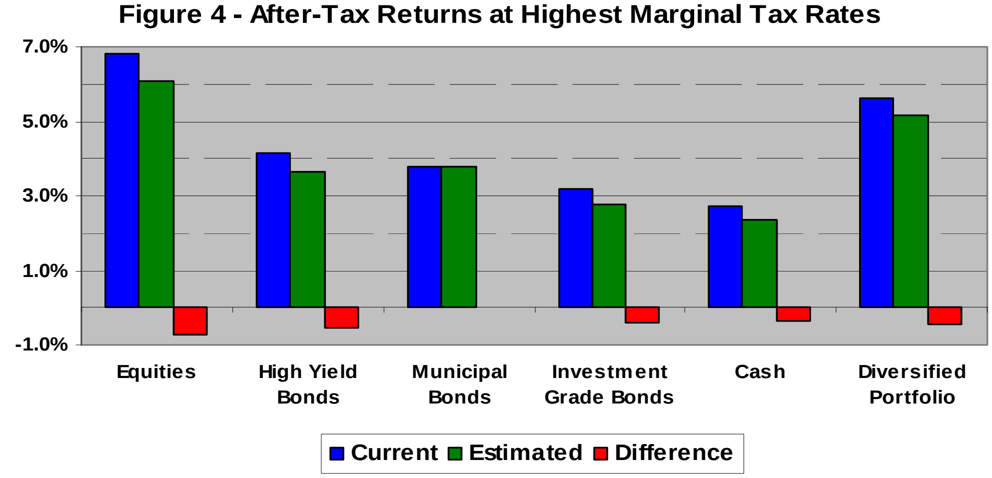
Higher tax rates have the negative effect of lowering returns for taxable investors. However, there is no evidence to suggest that overall market returns will be materially impacted by the higher tax rates that we will almost certainly see in the coming years. The return assumptions that we use for US equities and other assets take into account history that was lived out under many different tax regimes. The proposed increases which are currently under consideration are well within the context of this history. Consequently, we do not anticipate making any changes to the long-term return assumptions within our valuation process as a result of pending tax changes.

Our portfolio construction process for taxable investors explicitly accounts for income taxes. However, the after-tax estimates for long-term relative returns do not change enough, based on our assumptions, to warrant altering portfolio allocations at this time.

Figure 3 - US Asset Class Return Assumptions

	Before-Tax Returns	After-Tax Returns Current	After-Tax Returns Estimated	Difference
Equities	8.0%	6.8%	6.1%	-0.7%
High Yield Bonds	6.4%	4.2%	3.6%	-0.5%
Municipal Bonds	3.8%	3.8%	3.8%	0.0%
Investment Grade Bonds	4.9%	3.2%	2.8%	-0.4%
Cash	4.2%	2.7%	2.4%	-0.4%
Diversified Portfolio	6.5%	5.6%	5.2%	-0.4%

Figure 4 - After-Tax Returns at Highest Marginal Tax Rates



Note: Diversified Portfolio = 60% equities, 35% municipal bonds and 5% high yield bonds

"HIGHER TAX RATES HAVE THE NEGATIVE EFFECT OF LOWERING RETURNS FOR TAXABLE INVESTORS"

"THERE IS NO EVIDENCE TO SUGGEST THAT OVERALL MARKET RETURNS WILL BE MATERIALLY IMPACTED BY THE HIGHER TAX RATES THAT WE WILL ALMOST CERTAINLY SEE IN THE COMING YEARS."

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	14.4%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive
Eurozone	21.0%	5.8%		
Japan	12.2%	4.4%		
UK	15.6%	6.1%		
Emerging	1.8%	10.3%	neutral	Asset class above fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive
2-Year	0.8%	2.8%		
5-Year	0.9%	3.6%		
10-Year	1.5%	4.4%		
30-Year	1.8%	4.9%		
US Municipal Bonds			under	In most maturities, municipal bonds are overpriced
2-Year	0.7%	2.1%		
5-Year	0.9%	2.7%		
10-Year	2.1%	3.4%		
30-Year	6.2%	4.2%		
US High Yield	2.7%	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	0.5%	4.0%		
Japan 10-Year	-0.5%	1.8%		
UK 10-Year	1.7%	4.6%		
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	-5.3%	15.8%	-4.8%	Euro is moderately overvalued
Japanese yen	3.1%	15.3%	2.7%	Yen is near fair value
UK pound	-2.5%	13.2%	-0.8%	Pound is near fair value

Notes: **As of: April 30, 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.