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MONTHLY

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TAX-EFFICIENT INVESTING

Introduction

Benjamin Franklin once famously said, "In this world nothing is certain but death and taxes." The annual coming of spring and tax day brings the effects of taxation to the forefront of investors' minds. Unfortunately, the complexity of the US tax code and the fact that taxes are not tied to specific accounts can make it difficult to know how portfolio returns affect investors' wealth over time.

In this *Monthly* we review the current tax rates that apply to investment returns, analyze the after-tax return characteristics of various assets, and discuss the construction of tax-efficient portfolios. The examples that we present are based on current tax rates for individuals in the highest marginal tax bracket. Our analysis focuses on the effects of Federal taxes, since they have the biggest impact on investment returns and apply to all domestic investors. Generally speaking, future increases in tax rates should increase the benefits of tax-conscious investment strategies.

Taxes on Investment Income

Taxes on investment income are paid for the year in which the income is earned. In most cases, investment income is treated like income from employment, which is taxed at 35%.

A well known exception to this rule is interest from municipal bonds, which is most often exempt from federal taxation. Since in the long-term the majority of bond returns come from yield, taxable returns are largely a function of average yields. Therefore, when evaluating which bonds will produce the best results for portfolios, the yield that flows through to investors is extremely important. Figure 1 shows our long-term yield assumptions for municipal and taxable bonds, both before and after taxes. Taxable bonds generally enjoy higher yields than municipal bonds due to the structure of the market and investor demand. However, for investors in high marginal tax brackets, municipal bonds deliver better after-tax returns over time. This is why we tend to use municipal bonds as the core fixed income component for taxable portfolios, and taxable bonds for tax-exempt portfolios.

Dividends paid by US companies and registered foreign companies can also qualify to receive favorable tax treatment. If an investor holds an equity position for a spe-

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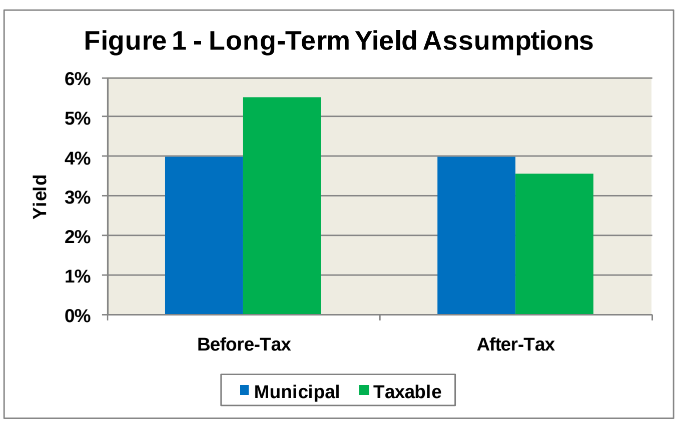

Source: Stairway Partners

CURRENT TOPIC

Tax-Efficient Investing

- *Introduction*
- *Taxes on Investment Income*
- *Taxes on Capital Gains*
- *Constructing Tax-Efficient Portfolios*
- *Conclusion*

Strategy

- *We made no strategy changes during the month of April.*
- *Portfolios remain modestly overweight developed market equity exposure and underweight bond exposure.*

"FOR INVESTORS IN HIGH MARGINAL TAX BRACKETS, MUNICIPAL BONDS DELIVER BETTER AFTER-TAX RETURNS OVER TIME"

Tax-efficient investing - cont'd

cific period around when a qualified company pays a dividend, they are taxed at a 15% rate. If the companies paying the dividends do not qualify or the investor's holding period is insufficient, then the dividends are taxed at the same 35% rate as ordinary income.

Taxes on Capital Gains

Taxes on capital gains differ from taxes on income in that they are only paid if the gains are realized by selling the appreciated asset. As a result, investors have the ability to defer capital gains taxes by not selling assets. Delaying the realization of capital gains can benefit investors if positions are held for at least one year, because long-term gains are taxed at a 15% rate. Short-term gains are taxed at the same 35% rate as ordinary income.

The deferral of capital gains realization can also benefit investors as accumulated gains are allowed to remain in the portfolio and compound, which can significantly increase long-term after-tax returns.

If securities are held directly, then investors have control over the realization of capital gains. However, if securities are held through a fund or separately managed account, then the behavior of the investment manager impacts the tax liability of the investor. Therefore, it is extremely important to take into account the likely effects of capital gains taxes resulting from portfolio activity when selecting a manager. These effects can be estimated by examining historical turnover, which measures the amount of annual activity relative to the size of the portfolio.

Studies conducted by Morningstar have shown that the average turnover for active equity and bond mutual funds exceeds 100%. This means that the average active manager sells the entire value of their portfolio more than once a year. As a result, active funds tend to realize a great deal of short-term capital gains, which increases the tax burden for investors. In contrast, passive funds have significantly lower turnover and can better manage gains and losses to substantially reduce realized capital gains. None of the passive equity ETF's that we use in Stairway Partners' portfolios has paid out a capital gain distribution since our firm's inception in 2004.

Constructing Tax-Efficient Portfolios

Because taxes represent a real cost to investors, the objective for portfolios that are subject to taxation should be to maximize after-tax returns. To accomplish this objective, we explicitly estimate long-term returns for assets on both a before and after-tax basis (see Figure 2).

The creation of a tax-efficient portfolio begins with the selection of an appropriate mix of assets, which usually includes investments like tax-exempt municipal bonds, and equities with qualified dividends and the potential to defer capital gains.

In addition to benefitting by incorporating tax-efficient assets, investors can greatly increase the tax-efficiency of their portfolio by using prudent managers who take advantage of deferred and long-term capital gains.

There are two aspects of Stairway Partners' investment process which produce these desired attributes of low turnover and tax efficiency. As mentioned earlier, we use broadly diversified passive ETF's and mutual funds, which have extremely low turnover and produce little or no capital gains. Also, as long-term fundamental investors, we seldom find ourselves in a position where recently purchased investments need to be sold. Going back over the past six years, this philosophy has resulted in annual turnover of roughly 15%, with the vast majority of realized gains being categorized as long-term.

To illustrate the benefits of our approach, we constructed two hypothetical portfolios, both having a $2 million starting value and an allocation of 60% equities and 40% bonds. Using our long-term after-tax return assumptions, we calculated the resulting value that investors would likely realize by holding these portfolios over

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Figure 2 - Long-Term Return Assumptions

	Before-Tax	After-Tax
Equities		
US	7.9%	6.7%
Developed non-US	7.9%	6.7%
Emerging	9.4%	7.7%
Fixed Income		
Taxable Core	5.5%	3.6%
Municipal	4.0%	4.0%
High Yield	7.4%	4.8%
Emerging	7.1%	4.6%
Cash	4.2%	2.7%

Source: Stairway Partners

"The objective for portfolios that are subject to taxation should be to maximize after-tax returns"

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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a 20 year time period. One portfolio was constructed to be tax-efficient using municipal bonds and assuming 15% turnover, with 90% of realized gains being long-term. These assumptions are consistent with the construction and transaction history of a taxable Stairway Partners' portfolio. The other portfolio was constructed with a more typical strategy, using taxable bonds and assuming 90% turnover, with only 20% of realized capital gains being long-term. These assumptions are consistent with the observed construction and turnover of actively managed funds.

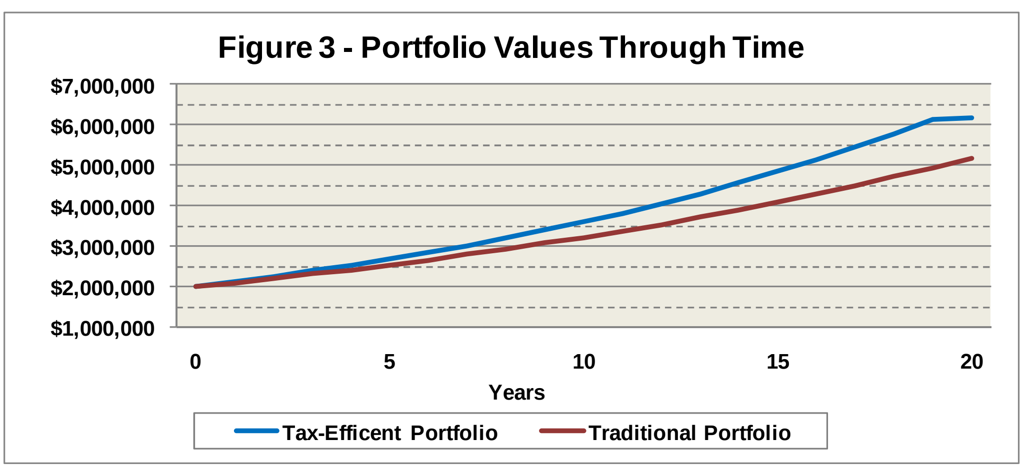
The reason that managers of balanced portfolios do not typically focus on tax efficiency is that independent consultants and fund rating companies like Morningstar tend to base their historical performance analysis on pre-tax returns. Since taxable bonds tend to produce higher pre-tax returns, they are often used without regard for their impact on investors' tax bills. This was evident in our study, where the *typical portfolio* produced higher pre-tax return of 6.9% relative to the 6.3% return of our *tax-efficient portfolio*.

The after-tax results, which are shown in Figure 3, tell a very different story. Assuming that all taxes were paid for both portfolios by the end of the 20 year period, the *typical portfolio* produced a 4.85% annual return and grew to $5.2 million. Even though the *tax-efficient portfolio* had a lower pre-tax return, it produced a 5.8% annual return after-tax and grew to $6.2 million over the same timeframe. The nearly 1% annual difference in after-tax returns led to 32% higher earnings for the *tax-efficient* portfolio. This example shows that the after-tax results for an individual investor can differ materially from the before-tax numbers that are more often observed.

Conclusion

To understand how investment returns will impact investors' wealth over time, it is important to understand not only the long-term return characteristics of the underlying assets, but also how these returns will be taxed. Many investors unknowingly hold portfolios that do not serve their best interests due to the difficulty of measuring after-tax returns and the fact that investment managers are most often evaluated based on pre-tax performance.

By choosing a manager who prudently manages turnover and constructs portfolios using tax-efficient assets, investors can greatly improve their results by lowering their taxes and keeping a greater share of the market's return.



Source: Stairway Partners

"The nearly 1% annual difference in after-tax returns led to 32% higher earnings for the tax-efficient portfolio"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	10.9%	4.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	24.5%	4.9%		
Japan	1.3%	3.8%		
UK	24.9%	4.9%		
Emerging	2.3%	8.0%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value
2-Year	0.1%	0.8%		
5-Year	-0.8%	1.1%		
10-Year	-0.6%	1.5%		
30-Year	-0.3%	1.7%		
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value
2-Year	0.3%	0.7%		
5-Year	-0.3%	1.0%		
10-Year	1.0%	1.3%		
20-Year	5.1%	1.5%		
US High Yield	1.3%	2.3%	over	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	-1.4%	1.4%		
Japan 10-Year	-0.3%	1.4%		
UK 10-Year	-3.2%	1.4%		
Canada 10-Year	-1.6%	1.5%		
Emerging Markets Debt	0.5%	2.5%	under	Sector is close to fair value
Cash	0.5%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.4%	17.8%	-6.7%	Euro is modestly above fair value
Japanese yen	-0.8%	0.6%	-1.0%	Yen is near fair value
UK pound	-2.4%	21.9%	-3.9%	Pound is near fair value

Notes: **As of: April 30, 2011**

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.