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MONTHLY

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EUROPEAN EQUITY UPDATE

Introduction

The government debt crisis in Greece, and fear that other weaker members of the European Union are destined for similar problems, have had a dramatic effect on the European Common Currency (the Euro), and global equity markets. Since the middle of April, the value of the Euro has declined by over 10%. Equity markets in Europe and the rest of the world have also declined. In the past six weeks, European equity markets have lost roughly 20% of their value.

Although the European debt crisis poses near-term risks to equity markets and the global economy, we believe that investors should stay focused on the fundamental factors that will have a lasting effect on portfolio returns. In this *Monthly* we will review our valuation process, critical assumptions and return forecasts for the Euro and for European equity markets.

The Euro

Well before the Greek debt crisis and general risk aversion caused the recent decline in the value of the Euro, we estimated that the currency was overvalued relative to the US Dollar. The October 2009 *Monthly* provided a detailed explanation of our currency valuation process and its implications.

Figure 1 compares our fair value exchange rate estimate to the market exchange rate for the Euro over time. The figure illustrates that the recent decline in the Euro has brought the currency much closer to our fair-value estimate. As a result, we view the recent correction as a fundamental adjustment rather than a collapse.

Dramatic changes in exchange rates are often accompanied by media coverage of negative structural issues pertaining to one side of the exchange rate equation. Today, the Euro is under pressure and the media is focused on European debt problems and the lack of an effective enforcement mechanism to police the

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CURRENT TOPIC

European Equity Update

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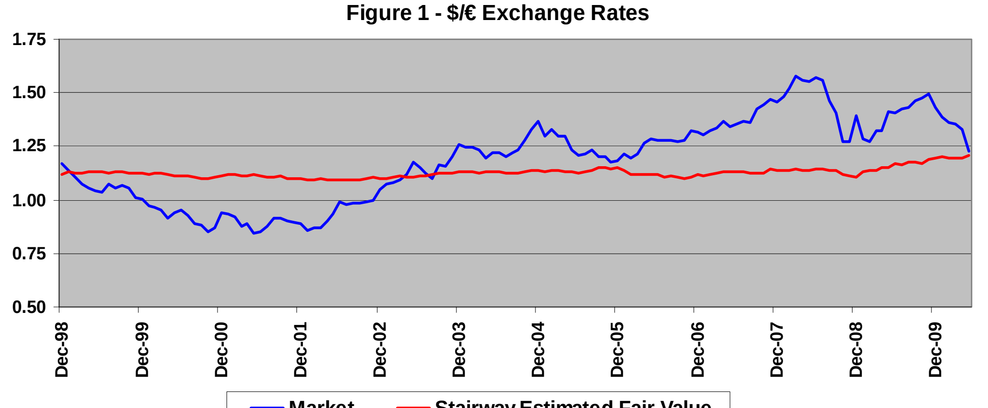
STRATEGY

- *We made no strategy changes during the month of May.*
- *Portfolio strategies remain overweight developed equity markets*

Figure 1 - $/€ Exchange Rates



Sources: Bloomberg, Stairway Partners

"THE RECENT DECLINE IN THE EURO HAS BROUGHT THE CURRENCY CLOSER TO OUR FAIR-VALUE ESTIMATE"

EUROPEAN EQUITY UPDATE - CONT'D

fiscal policies of member countries. Six months ago, the world looked quite different. The dollar was under pressure and the focus was on the US's fiscal deficit, the massive increase in the Fed's balance sheet and the potential for the dollar to lose its status as the world's reserve currency.

Unfortunately, investors tend to follow the media and often end up on the wrong side of market movements. This was certainly true this time around. In the second half of 2008, World Equity Funds had $90 billion of net outflows. The second half of 2009 saw the same funds get $33 billion in net inflows.

We believe that focusing on how fundamental economic and structural developments will effect both sides of the currency relationship is the best way to put exchange rate movements into perspective and helps investors avoid the pit-falls of momentum investing.

European Equities

Our valuation philosophy is that long-term valuation should be based on future cash flows, discounted by a rate that reflects the risk of the asset. For equities, our future cash-flow estimates are based on the likely path of corporate earnings. Figure 2 shows the reported earnings for the companies in the MSCI EMU index, which we use to represent European equities. The figure illustrates that earnings are quite volatile, but over the long-term follow a reasonably stable path of real growth. This more stable path is an important input to the valuation model that we use to generate our expected return forecast. Our current expected return for European equities is roughly 28%, making it the most attractive market of any that we follow.

Although it is true that future budget cuts may slow European economic growth and have a negative impact on corporate earnings, it is also true that the weaker Euro will increase the competitiveness of the European manufacturers and service providers, that would benefit from greater international demand for their exports.

P/E Ratios

Although Price/Earnings (P/E) ratios are not a part of our valuation framework, they can provide additional insight into equity prices. Many analysts find P/E ratios

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Figure 2 - MSCI EMU Earnings

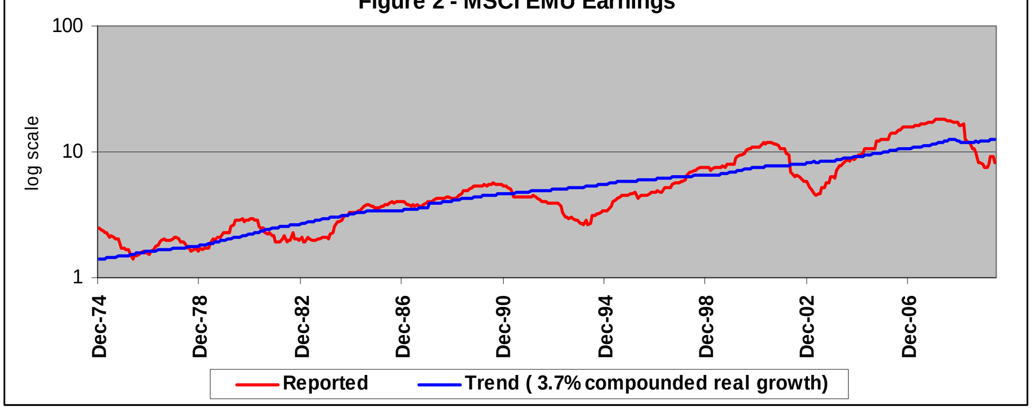
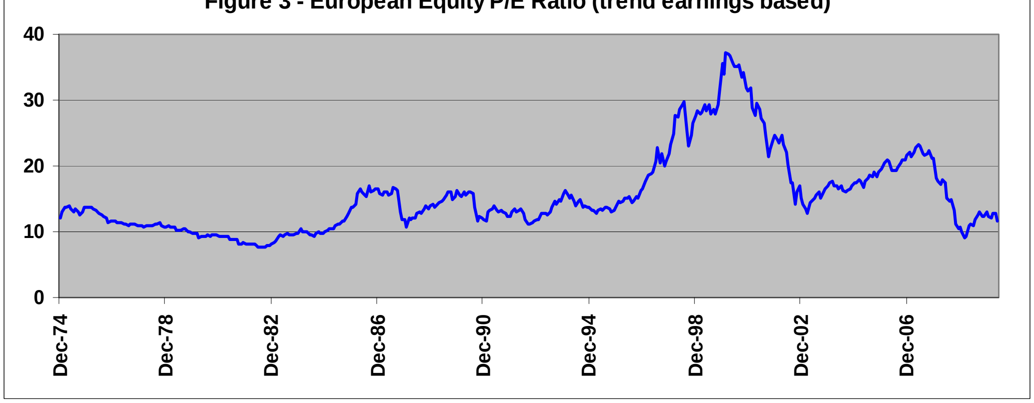


Figure 3 - European Equity P/E Ratio (trend earnings based)



Sources: MSCI, Stairway Partners

"EARNINGS ARE QUITE VOLATILE, BUT OVER THE LONG-TERM FOLLOW A REASONABLY STABLE PATH OF REAL GROWTH"

✻

"ON AVERAGE, THIS RATIO HAS BEEN 15 1/2 AND THE CURRENT LEVEL IS 12"

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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appealing because of their intuitive nature and relative simplicity. Equity prices and historical earnings, which are both observable, are the only inputs. Since both prices and earnings are volatile, P/E ratios can experience dramatic shifts in a relatively short period of time.

Figure 3 shows the history for a P/E ratio that we calculate for the European equity market. The earnings used to calculate this P/E ratio are taken from the long-term trend that is shown in Figure 2. On average, this ratio has been 15 ½ and the current level is 12. This reinforces the attractive valuation estimate produced by our cash-flow based model.

Strategy

In September of last year, we reduced our exposure to European equity and currency risk by cutting our overweight to non-US equities. Figure 4 shows our expected return estimates for European equities and the Euro at the time of the September strategy change and in November of 2008, when the larger overweight was established. During the roughly ten months that we maintained the larger overweight to non-US equities, the Euro and European equities performed very well. They were the largest contributor to the sector's positive 47% return for the period.

Since we reduced exposure in September, European equity markets and the Euro have underperformed significantly. This underperformance has increased the expected returns for European equities, which can also be seen in Figure 4. We have used the recent sell-off as an opportunity to rebalance and bring portfolios back up to our strategic target. If the current negative trend persists, we would look to increase our exposure to European equities.

Conclusion

In the past six months market sentiment has shifted dramatically, leaving European investments out of favor with global investors. We have stayed true to our investment principals and have taken advantage of market movements to opportunistically adjust our exposure to non-US equities. Although the European debt crisis poses near-term risks, our long-term fundamental valuation process indicates that European equities are attractively priced and that the Euro is currently very close to fair value. Absent any material changes to our forward looking valuation inputs, further deterioration of currency and equity values in Europe would provide us with an opportunity to increase our exposure to the region.

Figure 4 - European Market Expected Returns and Strategy Changes

As of	EMU Equity		Euro (€)		US$ Return	Changes to Non-US Equity Position
November 21, 2008	35.1%	+	1.9%	=	37.7%	Purchase to Increase Strategy Overweight
September 10, 2009	21.0%	+	-7.0%	=	12.5%	Sell to Decrease Strategy Overweight
May, 7 2010	28.6%	+	-1.0%	=	27.3%	Purchase to Rebalance

Source: Stairway Partners   Note: Expected Returns are annualized three-year estimates

"In September of last year, we reduced our exposure to European equity and currency risk"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	15.6%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	27.7%	5.5%		
Japan	5.0%	3.8%		
UK	31.1%	5.9%		
Emerging	7.4%	10.5%	neutral	Asset class close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive
2-Year	0.7%	2.1%		
5-Year	1.1%	2.8%		
10-Year	2.3%	3.6%		
30-Year	4.1%	4.1%		
US Municipal Bonds			under	In most maturities, municipal bonds are overpriced
2-Year	0.7%	1.6%		
5-Year	1.3%	2.2%		
10-Year	3.1%	2.9%		
30-Year	9.3%	3.7%		
US High Yield	5.2%	3.7%	over	Sector is attractive relative to other fixed income sectors
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	0.2%	3.5%		
Japan 10-Year	0.9%	1.3%		
UK 10-Year	1.6%	4.2%		
Emerging Markets Debt	3.8%	4.0%	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	-0.8%	26.9%	-0.5%	Euro is near fair value
Japanese yen	1.3%	6.3%	2.2%	Yen is near fair value
UK pound	1.3%	32.4%	2.9%	Pound is near fair value

Notes: **As of: May 28, 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.