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 8, ISSUE 6 JUNE 2011

CORPORATE EARNINGS UPDATE

Introduction

An equity investor in a company has a claim to a portion of all of the earnings that the company will generate in the future. As a result, earnings play a pivotal role in determining the value that market participants place on equity investments. Unfortunately, the volatility of earnings and the fact that future earnings are unknown make equities riskier than investments with more certain cash flows, like investment grade bonds.

The most recent economic cycle produced the largest swing in reported earnings since the great depression. Toward the end of 2007 the S&P 500 reached a high of 1,565 as annual earnings peaked at just over $90. The financial crisis and economic recession that followed this peak led to a massive decline in earnings and in the value of equities. By the end of the economic recession in June of 2009, annual operating earnings on the S&P 500 had declined by 57% to just under $40. The price of the S&P 500 dropped a like amount to 677.

Since then, the US economy has expanded and both real and nominal Gross Domestic Product (GDP) have surpassed their previous peaks. Corporate earnings have also made a dramatic recovery, but unfortunately it can be difficult to put this recovery into perspective against the backdrop of volatile market prices and evolving business conditions.

In this *Monthly*, we will review the relationship between economic activity and corporate earnings, examine the current state of US earnings relative to long-term trends, and compare the recent earnings recoveries for broad global markets.

Economics and Earnings Growth

Corporations derive their profits from economic activity, as consumers purchase the goods and services that companies produce. As a result, there is a strong link between the growth in the overall economy and the growth of earnings for the broad market.

Figure 1 illustrates that the

(Continued on page 2)

CURRENT TOPIC

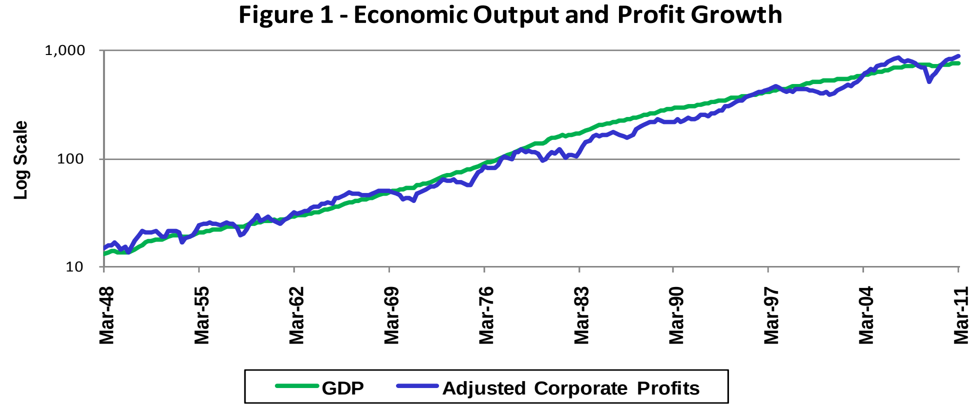
Corporate Earnings Update

- *Introduction*
- *Economics and Earnings Growth*
- *Long-Term US Earnings Trends*
- *Global Earnings Recovery*
- *Conclusion*

Strategy

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

Figure 1 - Economic Output and Profit Growth



Sources: Bureau of Economic Analysis, Stairway Partners

"THERE IS A STRONG LINK BETWEEN THE GROWTH IN THE OVERALL ECONOMY AND THE GROWTH OF EARNINGS FOR THE BROAD MARKET"

Corporate Earnings Update - Cont'd

long-term paths of GDP and corporate profits are indeed closely linked. The corporate profit series shown in Figure 1 is produced by the Bureau of Economic Analysis, who also publish GDP data. Both series have grown at roughly 7% per annum since the end of World War II, resulting in profits averaging about 9% of economic output.

The figure also shows that the path of earnings is not as smooth as the path of GDP. There are several reasons for this, which may include the effects of financial and operating leverage for corporations, and the government's willingness to expand its activity in times of recession.

Although it is useful to compare the earnings for US corporations to US economic activity, a broader comparison may tell a more complete story. Globalization has increased the linkage between earnings and economic growth between both developed and emerging countries. Since exports from manufacturers in emerging countries like China are sold to customers in developed countries like the United States, the growth of Chinese manufacturers may be somewhat limited by the growth in US demand. Likewise, companies in developed countries like Japan can enjoy stronger growth than their domestic economies would imply, if their products are sold in countries with faster growing economies. The effects of globalization are likely to continue, and should lead to further convergence in the earnings growth rates between markets going forward.

Long-term US Earnings Trends

As mentioned earlier, the value of equities is determined by the future earnings of the underlying companies. Because the bulk of this value will be determined over a long period of time, the long-term trend of earnings is an important factor in any fundamental valuation model. To determine a normal level for current earnings and to put future growth rate assumptions into perspective, we estimate long-term trends based on historical corporate earnings.

Figure 2 shows historical four quarter operating earnings for the S&P 500, along with our estimated trend which is based on historical inflation and real earnings growth. We use the S&P 500 as our primary source for US valuation because of the availability of analyst forecasts and greater transparency of underlying earnings data. The figure shows that the latest decline in earnings was extreme, but that it followed the typical cyclical pattern of recovery to a positive trend. The figure also shows that the most recent recovery has brought earnings modestly above our estimated long-term trend. As a result, we believe that US earnings may decline in the coming quarters.

Many analysts believe that a drop in earnings from today's level would justify a material decline in equity prices. However, the value of equities depends not only on future earnings, but also on the price that the market places on those earnings. This is evidenced by the fact that S&P 500 earnings are reaching new highs, while the value of the index is more than 10% below its pre-recession peak. We believe that US equity valuations are attractive based on our forward looking earnings assumptions, which include a modest near-term decline.

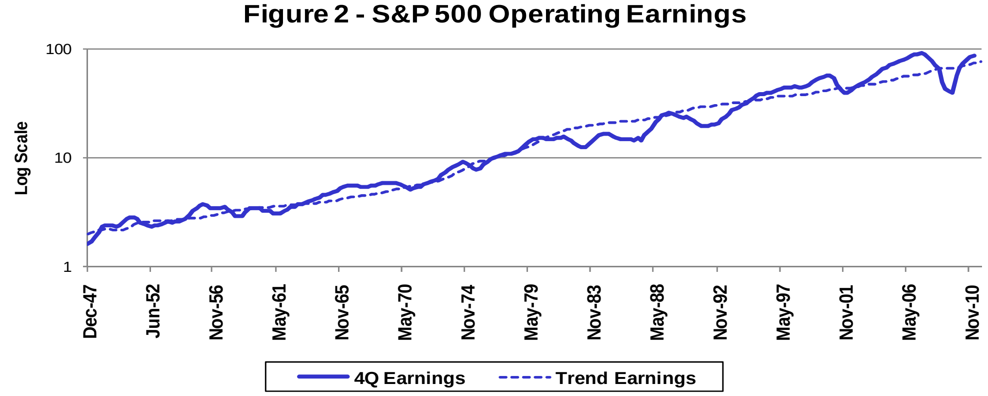
Global Earnings Recovery

US investors often focus exclusively on domestic measures of corporate earnings when evaluating equity markets. Since we manage globally diversified portfolios, it is necessary for us to track the earnings of companies in a diverse group of markets.

Figure 3 shows the composition of the global public equity market. Although the United States is by far the largest market, it only repre-

(Continued on page 3)

Figure 2 - S&P 500 Operating Earnings



Sources: Standard and Poor's, Stairway Partners

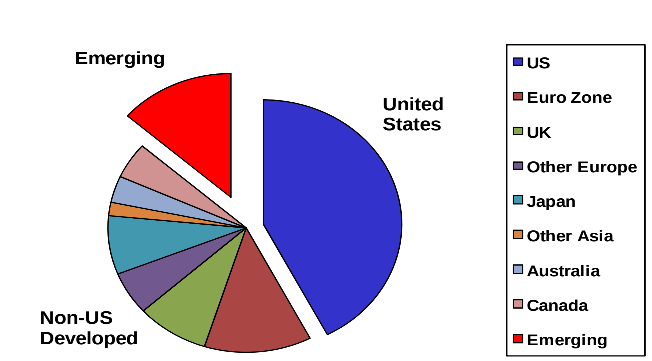
"The most recent recovery has brought earnings modestly above our estimated long-term trend"

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.

Figure 3 - Global Equity Market Composition



(Continued from page 2)

sents about 42% of the global equity market. Other developed countries like Japan, the United Kingdom, and Canada represent about 44% of the market, with the remaining 14% taken up by emerging market countries like China, Brazil, and Russia.

As discussed earlier, globalization has led to a closer relationship between the economic health of many countries and earnings of companies domiciled within those countries. Figure 4 shows how the most recent economic cycle has affected the earnings of companies in the US and selected foreign markets. The earnings for each market is represented by an index that we created using data from MSCI, a leading provider of global equity market information. The indices were constructed so that the pre-recession peaks equate to a value of 100. All of the markets shown experienced dramatic declines in earnings. However, the exact timing, magnitude, and the extent of the subsequent recovery differed significantly by market.

As mentioned earlier, the level of US earnings has recovered to beyond its pre-recession peak. Emerging market earnings experienced a more severe decline, but they too have more than fully recovered.

The earnings for companies in many developed countries outside of the US have improved dramatically, but have yet to fully recover from the last recession.

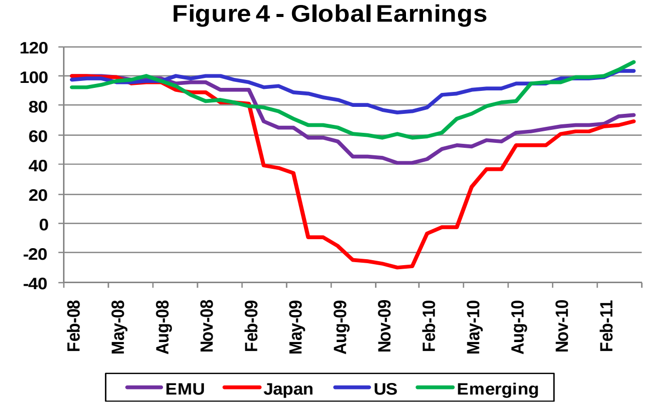
Conclusion

Earnings play an important role in determining the value of equity investments, but it is often difficult to put current earnings into perspective relative to volatile market prices and long-term historical trends. The most recent earnings cycle was extreme, but we believe that it can be viewed within the context of well established trends in global earnings and economic activity.

Earnings for US and emerging market companies have fully recovered from the effects of the last recession, although US equity prices remain more than 10% below their pre-recession peak. As a result, a modest decline in earnings would not leave valuations stretched by historical standards.

Earnings in many developed markets outside of the US have been slower to recover, but they too appear to be on a path to a full recovery.

Figure 4 - Global Earnings



"THE LEVEL OF EARNINGS HAS RECOVERED TO BEYOND THE PRE-RECESSION PEAK IN THE UNITED STATES"

Sources: MSCI, Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	11.5%	4.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	27.7%	4.9%		
Japan	2.6%	3.8%		
UK	26.6%	4.9%		
Emerging	4.9%	8.1%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value
2-Year	0.0%	0.8%		
5-Year	-1.6%	1.2%		
10-Year	-1.8%	1.7%		
30-Year	-2.3%	1.9%		
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value
2-Year	0.2%	0.7%		
5-Year	-0.7%	1.0%		
10-Year	0.1%	1.4%		
20-Year	3.8%	1.6%		
US High Yield	1.2%	2.6%	neutral	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	-2.4%	1.5%		
Japan 10-Year	-1.0%	1.5%		
UK 10-Year	-3.6%	1.5%		
Canada 10-Year	-2.4%	1.6%		
Emerging Markets Debt	0.0%	2.8%	under	Sector is modestly above fair value
Cash	0.5%	---		

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-4.7%	21.6%	-7.1%	Euro is modestly above fair value
Japanese yen	-0.9%	1.6%	-1.9%	Yen is near fair value
UK pound	-2.0%	24.1%	-4.4%	Pound is near fair value

Notes: **As of: May 31, 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.