

MONTHLY

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PRICING A NEW NORMAL

Introduction

Since early March, the US equity market has appreciated considerably leading some to believe that the market has gotten ahead of the fundamentals by pricing in a “V shaped” recovery in the economy. We would note that the US equity market is still down over 40% from its highs of October 2007. In fact, the broad US equity market has produced a negative annualized return of 1.28% over the last ten years (Figure 1). Talk about a lost decade in investing.

The equity market is ultimately dependent on underlying earnings of companies. Over the long run, earnings

have grown roughly in line with the economy but with considerably more volatility. This is a topic we have written extensively on in the past. The economic and financial distress of the last two years have produced record collapses in stock market earnings and consequently in equity prices. These events have caused many to believe it is different this time and that we’re in a new environment of slower growth going forward - a *new normal*. In this *Monthly* we discuss some of these concerns of investors and how, if we take them into account, our view of equities might be altered.

New Normal

This new normal is driven by perceived structural shifts that will have profound and long-lasting effects on the economy and ability of companies to produce earnings.

As we have witnessed in the past, when markets move considerably in either direction, this reactive behavior is typical. If structural shifts occur that were not anticipated, investors may not have a choice but to make some changes “after the fact”. However, any changes to the long-term outlook need careful consideration when evaluating markets.

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CURRENT TOPIC

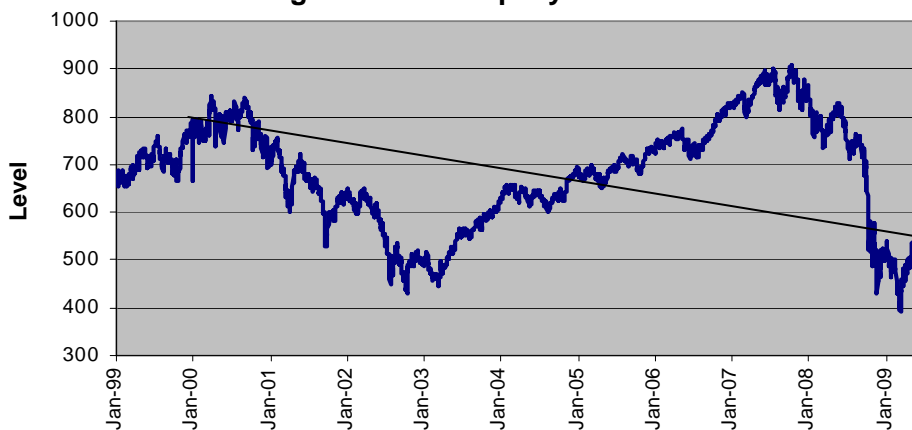
Pricing a New Normal

- *Introduction*
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- *Conclusion*

Strategy

- *Due to the dramatic rise in equity markets since March, we reduced equity exposures to bring them back in line with strategy*
- *Portfolio strategies remain overweight equity markets and high yield bonds*

Figure 1: US Equity Market



“THE US EQUITY MARKET IS WELL OFF ITS LOWS... BUT IS STILL DOWN OVER 40% FROM ITS HIGHS OF OCTOBER 2007.... AND HAS PRODUCED A NEGATIVE ANNUALIZED RETURN OF 1.28% OVER THE LAST TEN YEARS”

PRICING A NEW NORMAL - CONT'D

Some well-advertised drivers of the new normal include: 1) consumers, who after years of obtaining cheap credit, will have to repair badly damaged balance sheets and will have trouble contributing meaningfully to economic growth, 2) real estate markets, both residential and commercial, will take a very long time to recover, 3) big government, by virtue of its size and involvement in the private sector, will impede economic activity over a long period of time.

All of these points, and oth-

ers, could produce an economy that has permanently shifted lower, may not recover at a rate similar to the past and will eventually produce a new trend growth rate that is lower than past (or expectations).

To provide contrast we show two charts that put the current economic environment in perspective. Figure 2 shows, that even with the dramatic decline over the last several quarters, economic output has fallen by 2.5% on a year-over-year basis. This is a large number, over 320B

annualized, but smaller than many might think given the magnitude of the market declines and the fear that has persisted over the last nine months. Figure 3 shows that, despite the dramatic slowdown in the economy, productivity has held up remarkably well. Essentially companies have been expeditious in dealing with the drop in aggregate demand by reducing headcount. This reduction in headcount, along with aggressive inventory management, may be why earnings last quarter sur-

prised on the high side.

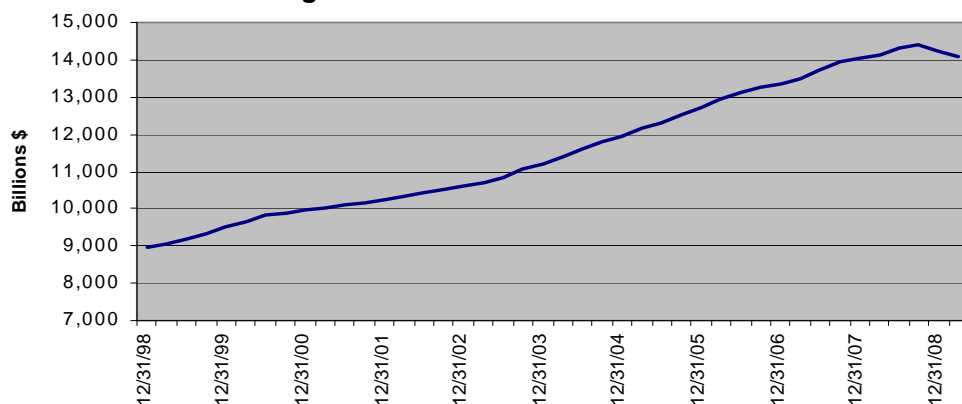
Valuation

As most of our readers know, our valuation process focuses on the long-term. In general, it is designed to avoid the extrapolation of cyclical events that often drive prices to extremes - both up and down.

From a fundamental perspective, we believe it is essential to focus on the earnings that can be produced over a longer period of time and

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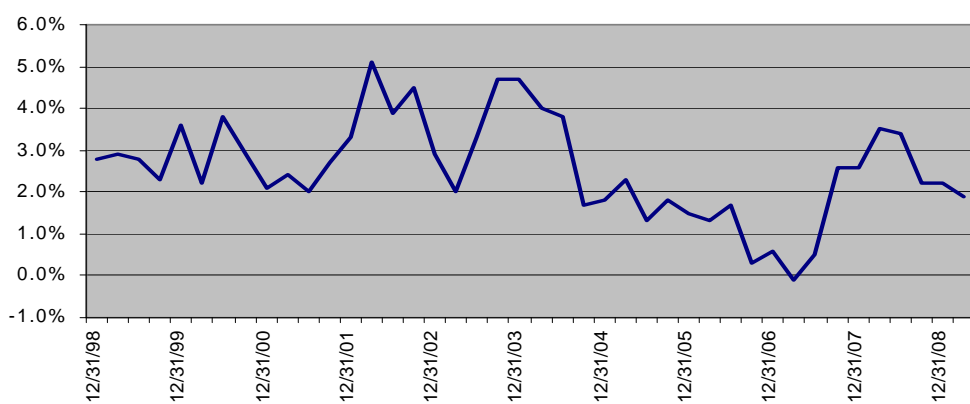
Figure 2: US Nominal GDP



“ECONOMIC OUTPUT HAS FALLEN BY 2 ½ % ON A YEAR-OVER-YEAR BASIS”

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Figure 3: US Productivity



“DESPITE THE DRAMATIC SLOWDOWN IN THE ECONOMY, PRODUCTIVITY HAS HELD UP REMARKABLY WELL”

Sources: Bureau of Economic Analysis, Bloomberg

Notes: GDP is a seasonally adjusted annual rate

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.

avoid the near-term volatility which can cause investors to buy or sell at inopportune times. Underlying our view is the belief that earnings and the economy will eventually revert to a normal level and growth rate.

To many, our approach leaves the impression that we lean against the “it is different this time” consensus. This process, which is not trading oriented, has helped us keep an anchor in volatile times. As an example, many thought we were too conservative on the earnings outlook in 2007 when we were underweight equities. Now many believe that we are too positive in our belief that equities, even after the run up from the March lows, have discounted a fair amount of bad news. The reality is that our assumptions have not changed

and we view this criticism as evidence that we have maintained our discipline.

Pricing the New Normal

While we have not changed our long-term assumptions, we recognize that the recent experience was unusually profound. As a result, we have *stressed* the inputs to our valuation model in an attempt to gain insight on how a new normal might affect our assessment or how markets are currently priced.

Figure 4 shows the impact of these changes on our valuation. The current output of our model shows the market priced 35.8% under fair value (FV). This fair value assumes the environment returns to normal over a three-year period. We believe this is consistent with the expectation of a “V”

shaped recovery.

If we reduce the real long-term growth rate by 8.3%, the reduction in fair value is 8.8% leaving the current market 31.1% undervalued. We alternatively reduce our assumption about the normal level, not the growth rate, of earnings by 15%. This reduces FV by 14% leaving the market 26.9% undervalued. The bottom row shows what happens if we do both - reduce the level and the long-term growth rate of earnings by said amounts. Even in this scenario, which reduces FV by 22.8%, the market still remains undervalued by 18.5%.

Conclusion

Despite the recent improvement, the US equity market remains considerably below where it was a year and a half

ago. The extreme stress experienced in the financial system has been a harrowing experience along with the decline in the economy. As a result, may have cited a new normal to describe the current environment for investing. In effort to better understand what might be already priced into the US equity market we evaluate what the impact of a new normal would have our longer-term assessment. The technique we use to gauge this involves stressing the inputs to our valuation model to capture the structural shifts that may be occurring. Our conclusion is that equity markets at current levels have sufficiently priced in a fair amount of bad news even if the US economy has moved to a new normal.

Figure 4: Valuation Model and the US Equity Market

Description	Reduction in FV	Market Relative to FV
Current Output	--	-35.5%
Reduce growth rate by 8.3%	-8.8%	-29.3%
Reduce level of earnings by 15%	-14.0%	-25.0%
Reduce both level and growth	-22.8%	-16.4%

“THE BOTTOM ROW SHOWS THAT EVEN IF WE REDUCE BOTH THE LEVEL AND GROWTH- RATE OF EARNINGS THE MARKET STILL REMAINS UNDERVALUED”

Source: Stairway Partners

Note: FV = Fair Value

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	23.9%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	28.1%	6.1%		
Japan	16.4%	4.4%		
UK	23.3%	6.2%		
Emerging	11.8%	10.8%	neutral	Asset class is attractive but developed equities priced better
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.7%	2.8%		
5-Year	0.8%	3.6%		
10-Year	1.5%	4.4%		
30-Year	1.3%	4.9%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	1.1%	2.3%		
5-Year	1.4%	2.8%		
10-Year	2.8%	3.6%		
30-Year	8.8%	4.5%		
US High Yield	14.6%	4.4%	over	Sector offers good return prospects relative to its risk
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	2.1%	4.3%		
Japan 10-Year	0.1%	2.0%		
UK 10-Year	1.3%	4.5%		
Emerging Markets Debt	5.0%	4.6%	under	Although sector is priced attractively, other asset classes offer better value
Cash	2.6%	---	minimal	
			10-Year	
	Expected	Equity	Bond Return	
	FX Change	Return with	with	
		Currency	Currency	
Currencies				
Euro	-7.7%	20.4%	-5.6%	Euro is moderately overpriced
Japanese yen	-1.6%	14.8%	-1.5%	Yen is slightly overpriced
UK pound	-0.6%	22.7%	0.8%	Pound is near fair value

Notes:
As of: May 31, 2009

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.

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