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MONTHLY

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MUNICIPAL BONDS IN CONTEXT

Introduction

Municipal bonds play an important role in the portfolios of many investors who pay taxes on income in the highest brackets. This is because the coupon interest from most municipal bonds is not subject to federal income tax. In this *Monthly* we will provide a framework for putting the tax benefits of municipal bonds into perspective and discuss risk characteristics that should be considered before including them in an investment portfolio.

The individual characteristics of municipal bonds and the legal status of the account in which they are held can affect the tax treatment of income. As a result, it is best to consult with a tax professional before investing in municipal bonds. The content of this *Monthly* is not meant as tax advice, but rather as a discussion of the relevant factors that investors should take into account when evaluating municipal bonds.

Current Environment

Since the beginning of 2009, investors have moved large amounts of money into municipal bond funds. Figure 1 shows that annual net purchases of municipal bond funds have been stronger than any other time in the past 25 years. There are several factors that we believe explain this large movement of investor capital. First of all, the low level of yields currently available in cash investments have resulted in many investors moving "out the yield curve" in search of income. Secondly, the increased volatility in global equity markets has changed the behavior of many investors, who now opt for more conservative portfolios. The evidence of this herd mentality can also be seen in outflows from equity mutual funds. Lastly, anticipation of the pending tax changes which were the subject of our May *Monthly* has increased investor's appetite for tax-sheltered income.

Comparing Income

Because markets are relatively efficient and investors are willing to accept lower yields for bonds with favorable tax treatment, municipal bond yields tend to be lower than equivalent-maturity taxable bonds.

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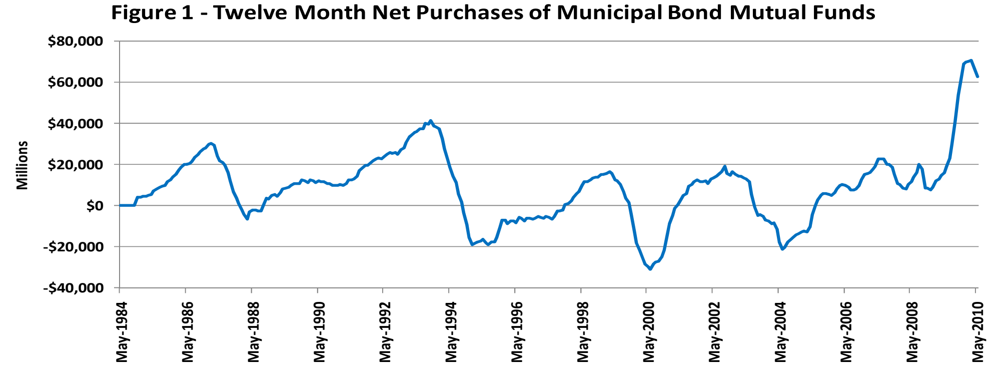
Figure 1 - Twelve Month Net Purchases of Municipal Bond Mutual Funds



Sources: Investment Company Institute, Stairway Partners

CURRENT TOPIC

Municipal Bonds in Context

- *Introduction*
- *Current Environment*
- *Comparing Income*
- *Risk Characteristics*
- *Conclusion*

STRATEGY

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

"INVESTORS HAVE MOVED LARGE AMOUNTS OF MONEY INTO LONG-TERM MUNICIPAL BOND FUNDS"

Municipal Bonds in Context - cont'd

Figure 2 shows that long municipal bond yields have not surpassed long corporate bond yields at any time since detailed data has been available. The relationship is similar between municipal bonds and US Treasuries. In most instances municipal bond yields are lower than Treasury yields. Although in times of extreme market stress (like the recent past), municipal bond yields have exceeded US Treasury yields.

In order to put the yields of municipal and taxable bonds onto a level playing field for comparison, one can "gross up" the yield of municipal bonds to adjust for the tax benefit. This measure is known as the taxable equivalent yield.

$$\text{Taxable Equivalent Yield} = \frac{\text{Tax Free Yield}}{(1 - \text{Tax Rate})}$$

Taxable equivalent yields are often compared to the yields of benchmark taxable bonds. The most common taxable bonds used to gauge the attractiveness of municipal bonds are US Treasuries. Although the relationship to Treasuries can provide insight into relative market valuations, we believe it is also appropriate to compare municipal bonds to other alternatives, like high-quality corporate bonds. This is because the average credit quality and liquidity of municipal bonds are much closer to high quality corporate bonds than they are to US Treasuries. As a result, yield changes (which drive principal gains and losses) for municipal bonds have followed corporate bonds more closely than Treasuries. This can also be seen in figure 2.

Using the most recent yield from the long municipal bond index (4.0%) and the current highest marginal tax rate (35%), we can calculate a taxable equivalent yield of 6.2% for long municipal bonds. Since the long corporate bonds have a yield of 6.0%, an investor subject to the highest marginal tax rate would achieve a slightly higher level of after-tax income with municipal bonds.

Another useful measure of relative yields is the break-even tax rate, which is the tax rate at which the advantage of municipal bonds tax-exempt status offsets the yield differential.

$$\text{Break-Even Tax Rate} = 1 - \frac{\text{Tax Free Yield}}{\text{Taxable Yield}}$$

The break-even tax rate can be used as a simple gauge to determine if an investor's current tax situation justifies holding municipal bonds. It can also be used to compare the current pricing of the municipal and taxable markets relative to expected future tax rates. Figure 3 shows the historical break-even tax rate calculated using long municipal and long corporate bond yields. There is a modest upward trend in the break-even tax rate over the past year, which is consistent with the view that individual income tax rates are likely to increase in the coming years. Without adjusting for risk, the current level of 34% indicates that only those investors who are subjected to the highest marginal tax-rate (35%) would maximize their after-tax income with municipal bonds.

Risk Characteristics

The tax treatment of municipal bond interest is what draws investors to the sector, but unfortunately it can result in a myopic focus on avoiding taxes. This often leads investors down the path of purchasing municipal bonds without fully understanding the risks. To determine how municipal bonds will impact the total return and risk profile of a portfolio, it is important to look deeper into the characteristics of municipal bonds and their taxable alternatives.

The municipal bond market is opaque and highly fragmented, making pricing of individual issues difficult. This can lead to higher transaction costs, which hurt investors in two ways. At the

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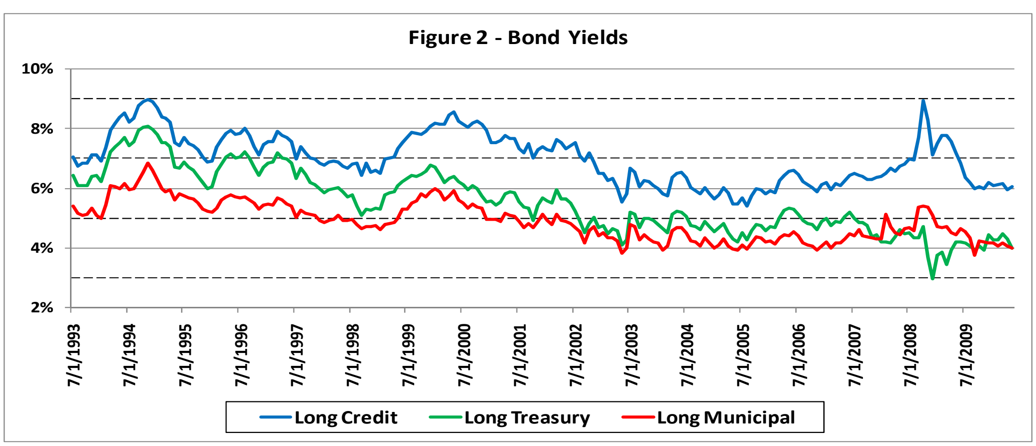

Source: Barclays Capital

"THE AVERAGE CREDIT QUALITY AND LIQUIDITY OF MUNICIPAL BONDS ARE MUCH CLOSER TO HIGH-QUALITY CORPORATE BONDS THAN THEY ARE TO US TREASURIES"

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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time of purchase, it is difficult to determine if offering yields are competitive relative to other municipal bonds that may be available. The lack of transparency also leads to large bid/offer spreads, which make it expensive for investors to rebalance portfolios or meet liquidity needs.

Proper diversification of credit risk is also very important when investing in municipal bonds. Long holding periods and changing municipal credit conditions can often leave investors with riskier positions than originally intended.

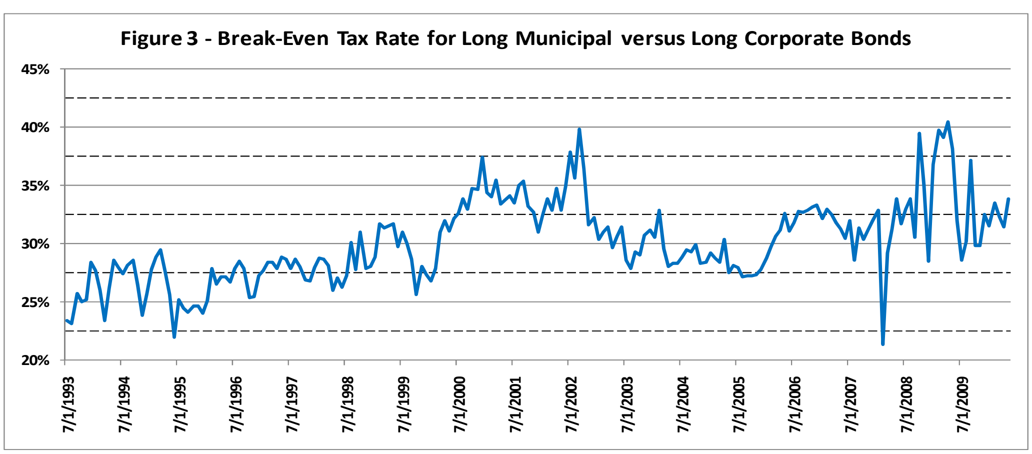
These issues of liquidity and diversification can both be overcome by investing in municipal bonds though a diversified investment vehicle, like a mutual fund. Since shares of mutual funds are transacted at the fund's net asset value (NAV), redemptions do not entail paying a bid/offer spread. Funds also offer diversification that is difficult to achieve in an individual portfolio. The municipal bond fund most commonly used by Stairway Partners in client portfolios contains well over 800 bonds, with the top 10 holdings accounting for less than 5% of the portfolio.

Another factor to keep in mind when comparing municipal bonds to taxable bonds is that taxable bonds can offer greater diversity in terms of exposure to market sectors like agency mortgages and US Treasury bonds. Due to their significantly lower credit risk, these sectors have exhibited a lower correlation to equity markets over time, and therefore provide more diversification benefits.

Finally, many municipal bonds are callable, which leaves investors more exposed to the negative implications of higher yields than they are to the positive implications of lower yields. As an example, assume an investor purchases a 10 year bond which is callable in 1 year. If rates increase, the bond will not be called and the investor will be left receiving below market coupon payments for 10 years. If on the other hand rates decline, the bond will be called and the investor will be forced to reinvest at lower interest rates. This adverse phenomenon is known as negative convexity.

Conclusion

Low interest rates, increased market volatility and the fear of higher tax rates have driven more investors into municipal bonds. Since they generally have lower yields, investors should look at their own tax status and the yields of taxable alternatives to determine if municipal bonds will truly produce the highest after-tax income in their individual portfolio. It is also important for investors to look beyond the simple income differences to analyze how the risk and total return profile of their overall portfolio will be impacted by the addition of municipal bonds.



Sources: Barclays Capital, Stairway Partners

"The current level of 34% indicates that only those investors who are subjected to the highest marginal tax rate would maximize their after-tax income with municipal bonds"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	18.3%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	28.8%	5.6%		
Japan	4.2%	3.8%		
UK	33.7%	5.9%		
Emerging	9.4%	10.6%	neutral	Asset class close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive
2-Year	0.5%	2.0%		
5-Year	0.6%	2.7%		
10-Year	1.5%	3.4%		
30-Year	2.9%	4.0%		
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value
2-Year	0.6%	1.6%		
5-Year	1.3%	2.2%		
10-Year	3.0%	2.9%		
30-Year	9.4%	3.7%		
US High Yield	4.9%	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	0.4%	1.2%		
UK 10-Year	1.1%	4.1%		
Emerging Markets Debt	3.2%	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	-0.7%	28.1%	-0.6%	Euro is near fair value
Japanese yen	0.2%	4.5%	0.6%	Yen is near fair value
UK pound	0.2%	33.9%	1.4%	Pound is near fair value

Notes: **As of: June 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.

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