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MONTHLY

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PRICING SHORT-TERM EVENTS

Introduction

Markets can be extremely volatile as investors are forced to digest a never-ending stream of new and often conflicting information. Looking back, it is easy to find examples of stories that evolved with changing investment implications. The threat of deflation from weak economic growth and financial turmoil quickly morphed into the threat of inflation from the stimulative policies that were put in place to combat the weak economic growth and financial turmoil. Similarly, the threat of the European common currency depreciating due to excessive indebtedness of weaker members has been replaced with dollar weakness resulting from a Washington standoff on how best to deal with our own nation's indebtedness. The gyrations in equity prices that accompany these events can leave investors fearful or greedy at the wrong times. They are also a good indication that markets tend to over-react to headline news.

As long-term investors, we have always advocated looking beyond current headlines and focusing on the trends that drive investment returns over time. This is not to say that we believe current events should be ignored. Rather, we employ a fundamental valuation process that allows current conditions and short-term disruptions to be included in our estimates of future returns.

In this *Monthly,* we discuss how the effects of short-term market events can be quantified within our long-term valuation framework. To illustrate the point, we analyze two examples of potential market moving events within the context of expected equity market returns.

Valuation Framework

Correctly identifying long-term trends in the factors that drive investment re-

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CURRENT TOPIC

Pricing Short-Term Events

- *Introduction*
- *Valuation Framework*
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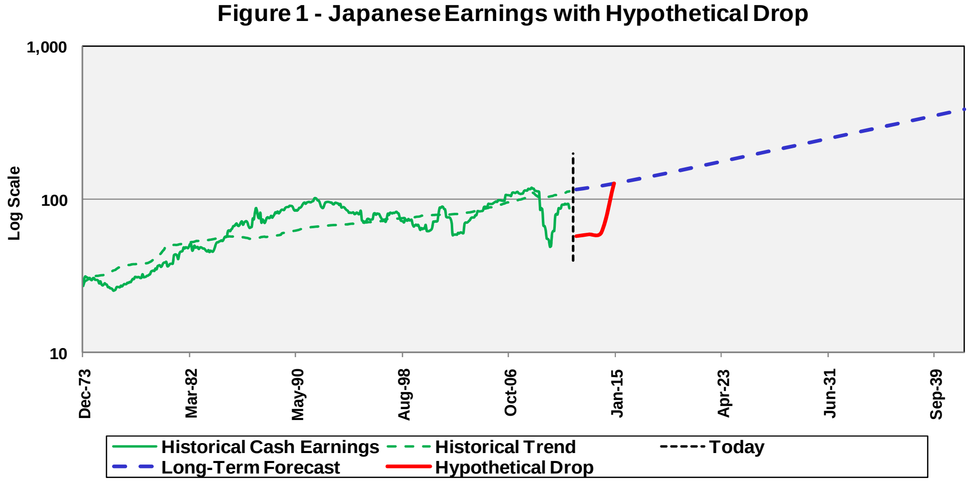
- *Timing of Fed Policy Changes*
- *Conclusion*

Strategy

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

"JAPAN EXPERIENCED AN EARTHQUAKE, TSUNAMI, AND NUCLEAR CRISIS THAT LED TO A DRAMATIC REDUCTION IN MANUFACTURING AND BUSINESS ACTIVITY"

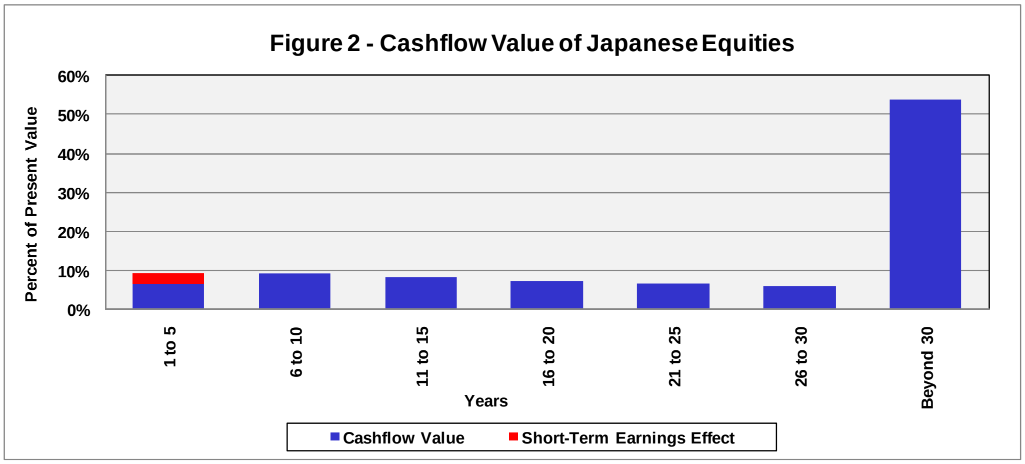
Figure 1 - Japanese Earnings with Hypothetical Drop



Sources: MSCI, Stairway Partners

PRICING SHORT-TERM EVENTS - CONT'D

"THE EFFECTS OF CUTTING EARNINGS IN HALF FOR THREE YEARS AMOUNTS TO A RELATIVELY MODEST 2 ½% REDUCTION IN TOTAL VALUE"



turns is the most important task for fundamental investors. However, market disruptions or unexpected changes in cash rates can materially affect expected returns over a reasonable investment horizon. This is why we believe that it is important to incorporate short-term market conditions into a long-term valuation process.

Generally speaking, our valuation process can be divided into two main components; the estimation of future cash flows, and the determination of the discounting rates needed to calculate the present value of those cash flows.

For equities, future cash flows are based off of projections of aggregate corporate earnings. We have written extensively on this topic in the past, most recently in the June 2011 *Monthly* – Corporate Earnings Update.

Discounting rates for all assets including equities are a combination of anticipated cash rates and risk premiums. Since we base our assumptions on long-term market volatility which is relatively stable, our risk premiums change little through time. However, cash rates do change over time, based on changes in the Federal Reserve Bank's (Fed) monetary policies.

Cash-Flow Disruptions

In March of this year, Japan experienced an earthquake, tsunami, and nuclear crisis that led to a dramatic reduction in manufacturing and business activity. We use this tragic event as an example to show how a short-term disruption in corporate earnings can affect expected equity returns.

Figure 1 shows the historical cash earnings for companies in the MSCI Japanese equity index. The history includes a decline in the first half of 2011, which is attributable to the recent natural disaster. The figure also shows the forward-looking forecast of earnings that drives our fundamental valuation of the Japanese equity market.

To illustrate the effects of a short-term deviation in earnings, we incorporated a severe near-term drop in earnings for Japanese companies. In this hypothetical example, we reduced earnings to 50% below our long-term trend for the next three years. This drop in earnings exceeds what occurred during the most recent economic recession and financial crisis.

To determine the effect on the fair value of Japanese equities that such a drop in earnings would have, we calculated the present value of the expected future cash flows, with and without the disruption. Figure 2 shows the present value of these expected cash flows. Because an equity investment represents a claim on future earnings in perpetuity, the majority of the value for equities comes from cash flows in the distant future. In this case, over half of the value of the Japanese equity market comes from earnings that are projected more than 30 years in the future. As a result, the effects of cutting earnings in half for three years amounts to a relatively modest 2 ½% reduction in total value.

As is often the case, the market reaction was more extreme. In the days immediately following the disaster, market prices for Japanese equities dropped nearly 18%. Within a week, the market went up by 12% leaving prices roughly 8% lower than before the crisis.

Timing of Fed Policy Changes

Cash rates are imbedded in the discount rates used to evaluate all investments. For equities, where the majority of the cash flows are anticipated to come in the distant future, the long-term equilibrium cash rate has the largest impact on valuation. Our

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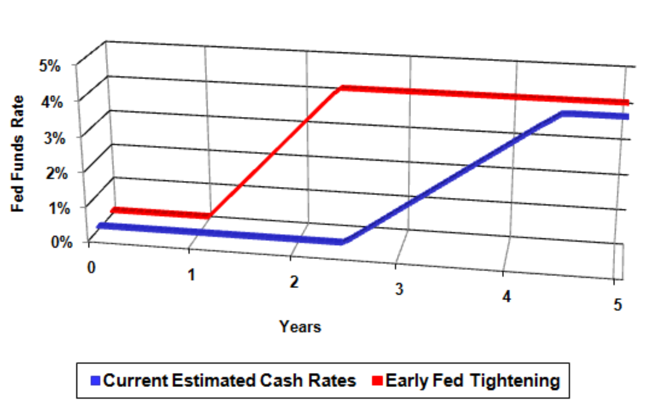
Sources: MSCI, Stairway Partners

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 - Estimated Cash Rates



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equilibrium cash rate is very stable at just over 4%. However, as was the case with earnings disruptions, short-term changes in cash rates can also impact long-term valuations.

To illustrate how these changes in cash rates impact equity valuations, we examine the effects that the timing of the Fed's monetary policy decisions can have on the expected returns for US equities. Figure 3 shows our expected path for US cash rates, which assumes that rates stay near zero for roughly 2 ½ years before they increase to just over 4% in the subsequent two years. Figure 3 also shows an alternative path, where rates begin to rise in one year's time and increase to the same level in roughly half of the time it takes in our expected path.

In our valuation model, we discount cash flows using the average cash rate that is expected to exist between the current time and when the cash flows are received. This means that the effects of short-term differences in cash rates diminish over time, as they become a smaller part of longer time periods.

Figure 4 shows the effects that the earlier and more aggressive Fed tightening would have on our US Equity discount rate curve. Between years one and five the effects of the early tightening are relatively large, but then fade over time as they become a smaller portion of the overall discounting period.

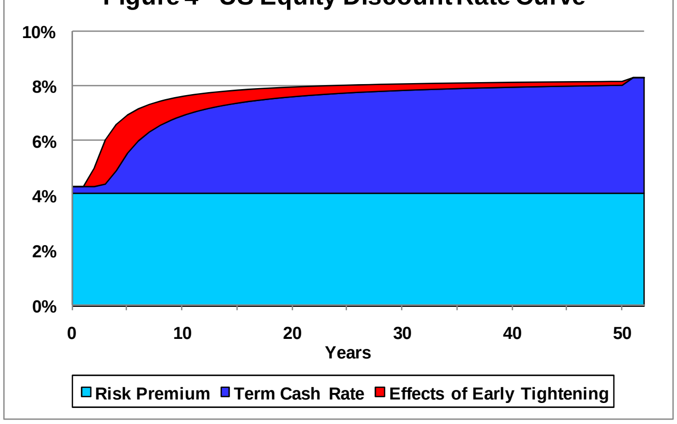
In this case, the higher discounting rates lower the present value of the US equity market by 5.4%.

Conclusion

Long-term factors, including sustainable earnings trends and equilibrium cash rates, are extremely important to investors who base their decisions on fundamental analysis. However, short-term events can also have an impact on valuations and should not be ignored.

More often than not, markets over-react to headline news. This may be because many investors lack an explicit framework that can be used to put current events into perspective. The ability to quantify the impact of temporary market disruptions can help investors to look through the noise of headline news and make more informed long-term investment decisions.

Figure 4 - US Equity Discount Rate Curve



> "Short-term difference in cash rates diminish over time as they become a smaller part of longer time periods"

Source: Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	14.4%	4.1%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	30.7%	4.3%		
Japan	2.2%	4.3%		
UK	27.8%	4.3%		
Emerging	6.2%	5.8%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value
2-Year	-0.2%	0.9%		
5-Year	-2.4%	1.4%		
10-Year	-3.0%	1.9%		
30-Year	-3.4%	2.2%		
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value
2-Year	0.2%	0.8%		
5-Year	-0.8%	1.1%		
10-Year	0.0%	1.6%		
20-Year	3.6%	1.8%		
US High Yield	1.5%	3.1%	neutral	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	-4.6%	1.7%		
Japan 10-Year	-2.8%	1.8%		
UK 10-Year	-3.9%	1.7%		
Canada 10-Year	-3.4%	1.8%		
Emerging Markets Debt	-0.7%	3.3%	under	Sector is modestly expensive
Cash	0.5%	---		

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-4.2%	25.2%	-8.6%	Euro is modestly above fair value
Japanese yen	-2.2%	0.0%	-4.9%	Yen is near fair value
UK pound	-1.8%	25.4%	-5.2%	Pound is near fair value

Notes: **As of: August 1, 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.