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MONTHLY

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EMERGING ISSUES

Introduction

Investors have seen returns in emerging equity markets far outpace developed equities over the last 5 years. More recently – since the start of this year – emerging markets have underperformed dramatically, as equity markets overall have declined. In the past few years, much had been made of "decoupling" – the notion that emerging markets would be immune to, or at least resistant to, economic and financial problems in the US and Europe. The success of emerging equities may, in fact, have been driving some of this thinking.

In this *Monthly*, we look at a number of the emerging equity indices, focusing on BRIC (Brazil, Russia, India, China), with an eye toward investigating some of the differences within this asset class.

Market Observations

Chart 1 shows that the MSCI Emerging Markets Index rose from 900 at the start of 2007 to exceed 1300 toward the end of October '07. This price gain of approximately 45% took only about 10 months to occur – an extremely rapid appreciation. In addition, this rise came on top of a more-than-tripling of the index's value in the 4 years from the end of 2002 to the end of 2006. In the 10 months subsequent to October '07, all of the 45% gain enjoyed in the first 10 months of the year was given back. The steep ascent and descent of emerging equities has an interesting contrast with developed equity markets, which had much less dramatic moves (Figure 2).

Within the emerging equity asset class, however, there has been considerable dispersion of performance. While much of the emerging markets hype seems to have been centered on BRIC as if

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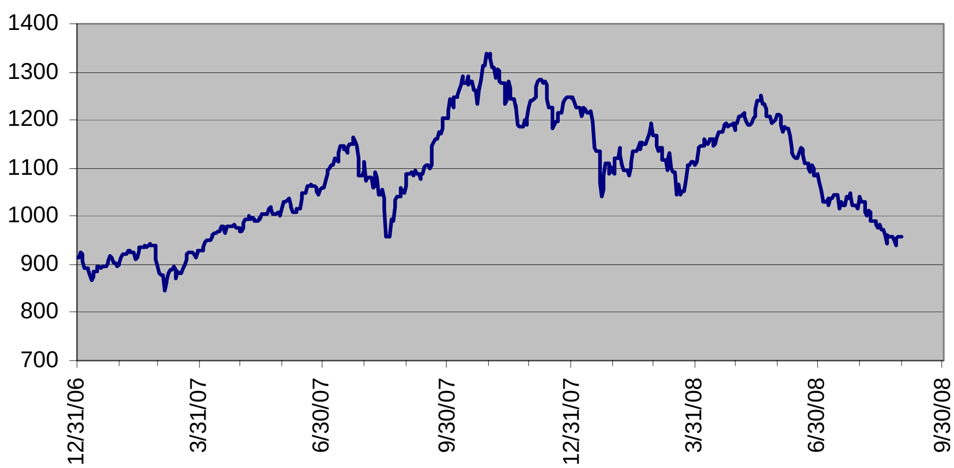
Strategy

- *We made no changes to strategy during the month of August*
- *Portfolios remain overweight US equities and underweight non-US equities*

Figure 1: MSCI Emerging Equity Index



Source: MSCI

Note: Index in US dollars

"IN THE TEN MONTHS SUBSEQUENT TO OCTOBER '07, ALL OF THE 45% GAIN ENJOYED IN THE FIRST 10 MONTHS OF THE YEAR WAS GIVEN BACK"

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the entire asset class was a homogenous monolith, Figure 3 shows how the four markets included in that designation have followed quite diverse paths. (Note that the four BRIC markets account for nearly 50% of total emerging markets index weight - Brazil #1, China #2, Russia #4, China #7.) One observation that is readily apparent is that Russia had seriously lagged the other three markets for most of 2007.

Commodity Exposure

In examining Figure 3, we can posit one explanation for the differential performance. In BRIC, two of the countries are commodity producers and exporters – Brazil and Russia – while two are importers and consumers of large quantities of commodities – China and India. In fact, this commodity producer/consumer difference might justify some of the divergence in the equity markets.

As Figure 4 shows, commodity prices rose strongly from the start of '07 to earlier this summer, with some more than doubling over this period. Referring back to Figure 3, we can see that the Brazilian and Russian markets – the commodity producers – peaked shortly before the commodity price peak. Many investors had been adding to commodities and emerging markets simultaneously, resulting in increased portfolio sensitivity to this relationship. In contrast, the commodity consumers' markets – China and India – began falling much earlier, as sharply rising input materials costs put pressure on their economies and companies. It is interesting that China's equity market did not stay strong through the Olympics, contrary to what many observers had forecast.

Sensitivity to Developed Markets

Developed equity markets peaked in early October '07. Subsequently, the US market fell roughly 20% from that high to its recent trough, while EAFE (non-US developed equities) fell about 25% from its high to low.

Looking back to Figure 3, we can see that this peak and decline in developed equity markets corresponds almost

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Figure 2: Global Equity Indices

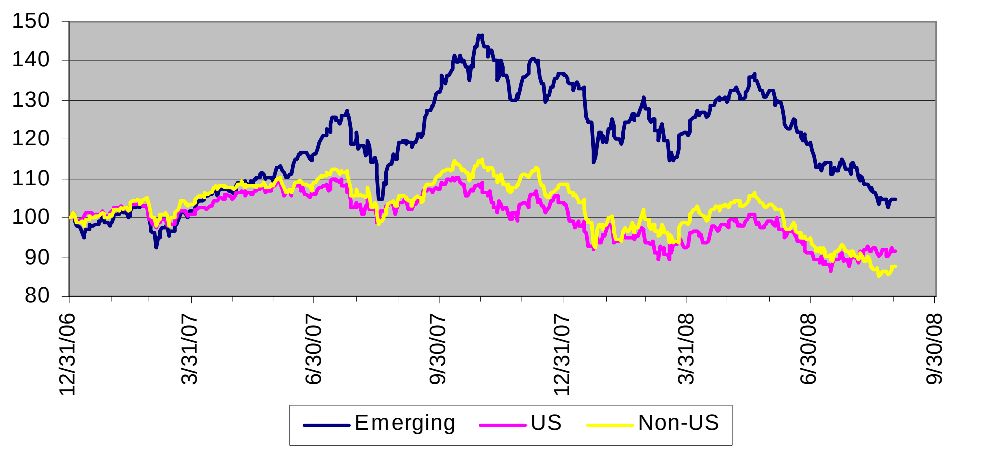
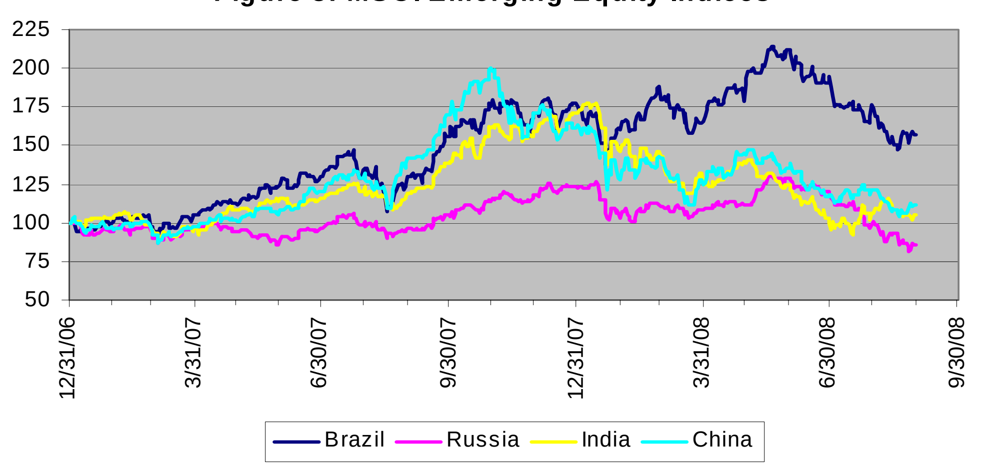


Figure 3: MSCI Emerging Equity Indices



Sources: MSCI, Russell   Note: Indices in US dollars, indexed to 100 as of 12/31/06

"WE DISAGREED WITH THE HYPOTHESIS THAT EMERGING EQUITIES WOULD "DECOUPLE" FROM THE DEVELOPED MARKETS"

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.

exactly to the peak and decline in China. The relationship between developed markets and India was less close. So, whereas the commodity producers' equity markets were "sensitive" in a positive way to commodity prices, the commodity users were sensitive to the condition of the "rest of the world". We believe that the weakness in developed economies is having an impact on China, where goods exports account for a significant share of economic growth.

The critical point to understand is that these emerging markets could not disconnect from the markets they sell into (export to). There was essentially a squeeze as their input costs were rising and demand for their output weakening.

Investment Implications

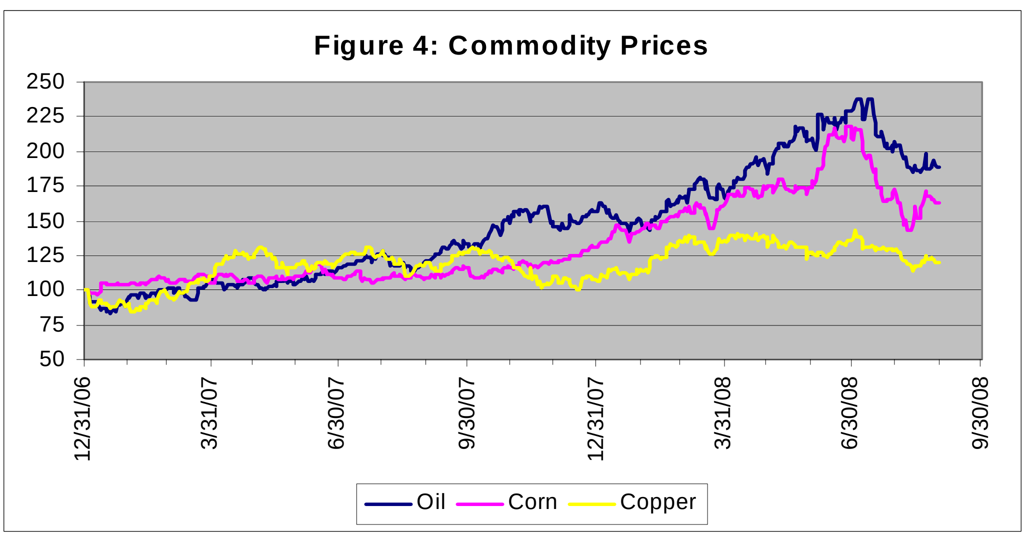
Looking back at our investment strategy, we have held emerging equities in portfolios to minimum allowable allocations. Our valuation work indicated that this asset class was overpriced, as investors had driven stock prices up too far and too fast. We disagreed with the hypothesis that other investors in this market seemed to accept: that emerging equities would "decouple" from the developed markets, particularly the US. This clearly turned out not to be the case.

Looking forward, we expect that the connection of emerging markets to the rest of the world will remain strong, i.e. that the decoupling thesis will continue to be false. So, in evaluating risks and returns of emerging equity, the trend will still be toward greater global financial market integration. Emerging and developed markets will be more, rather than less, related. While growth rates should be higher in emerging than in developed, the risks are likely to remain higher as well. In addition, we see the current prices of emerging equities as still at somewhat of a premium to developed equities where expectations are not nearly as optimistic.

Conclusion

Emerging equity markets have not been immune to the problems elsewhere in the world and have experienced significant declines from their highs. Within the emerging equity markets index, dispersion of performance has been pronounced. Commodity producing and exporting countries were buoyed by continuing strength in commodity prices until early this summer, but have fallen sharply since then. Commodity users, on the other hand, were hurt much earlier by weakening export markets (the developed world) and by the pressure of strengthening input prices.

We expect that the future will not be terribly different from the past when it comes to the notion of decoupling. While many had hoped that growth in emerging markets would shield them from weakness elsewhere in the world, this did not happen. Nor do we expect that it will become valid in the future. Increasing financial market integration will likely be reflected in continued strong correspondence between emerging and developed equities.



Sources: Bloomberg, Haver

Note: Indexed to 100 as of 12/31/06

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	11.4%	7.0%	small over	Exposure slightly above benchmark weight
Non-US Developed			small under	Asset class has become more attractive as markets have fallen
Eurozone	14.0%	7.9%		
Japan	3.1%	4.6%		
UK	14.0%	8.6%		
Emerging	3.1%	11.7%	under	Asset class remains expensive
Fixed Income				
US Treasury Bonds			neutral	Non-Treasury sectors more attractively priced
2-Year	2.2%	3.5%		
5-Year	2.1%	4.0%		
10-Year	2.1%	4.5%		
30-Year	2.0%	4.9%		
US Municipal Bonds			neutral	Sector overall is near fair value
2-Year	2.3%	2.8%		
5-Year	2.7%	3.3%		
10-Year	3.8%	3.8%		
30-Year	8.0%	4.4%		
US High Yield	10.5%	5.5%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields have been rising toward fair levels
Euro 10-Year	3.5%	4.6%		
Japan 10-Year	0.0%	1.9%		
UK 10-Year	3.4%	5.0%		
Emerging Markets Debt	3.6%	5.7%	under	Spreads over US Treasuries remain too tight
Cash	3.5%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-7.6%	6.4%	-4.2%	Euro is expensive
Japanese yen	3.2%	6.3%	3.1%	Yen is close to fair value
UK pound	-3.2%	10.8%	0.2%	Pound is expensive

Notes: **As of: August 31, 2008**

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.