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MONTHLY

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ACTIVE ALLOCATION AND TAXES

Introduction

Choosing the right mix of investments to meet long-term financial goals can be challenging. Future market returns are uncertain, and for many investors, the effects that taxes will have on those returns can be difficult to anticipate.

To make the most of market returns, taxable investors should take income and capital gains taxes into account when making investment decisions. We addressed this topic as it relates to long-term asset allocation in the May 2011 *Monthly*, titled Tax-Efficient Investing.

In this *Monthly*, we focus on how Federal taxation impacts the returns that investors realize over shorter time horizons. State taxes are ignored because they vary significantly amongst our readers. We also highlight enhancements that we have made to our reporting of expected returns, which are now shown on the last page of this publication and on the Stairway Partners website.

Investment Horizon and Taxes

We believe that all investors benefit from the discipline and stability that comes from a long-term investment perspective. A longer time horizon further benefits taxable investors, as they realize profits through long-term gains, which receive preferential tax treatment. For US investors with income in the highest marginal tax bracket, gains realized on investments held for one year or less are currently taxed at the same 35% rate which applies to ordinary income. Gains realized on investments held more than one year are taxed at a more advantageous 15% rate. As a result, trading profits that are realized within a one year timeframe do not benefit taxable investors as much as profits that are realized over a longer time horizon.

Figure 1 shows the before

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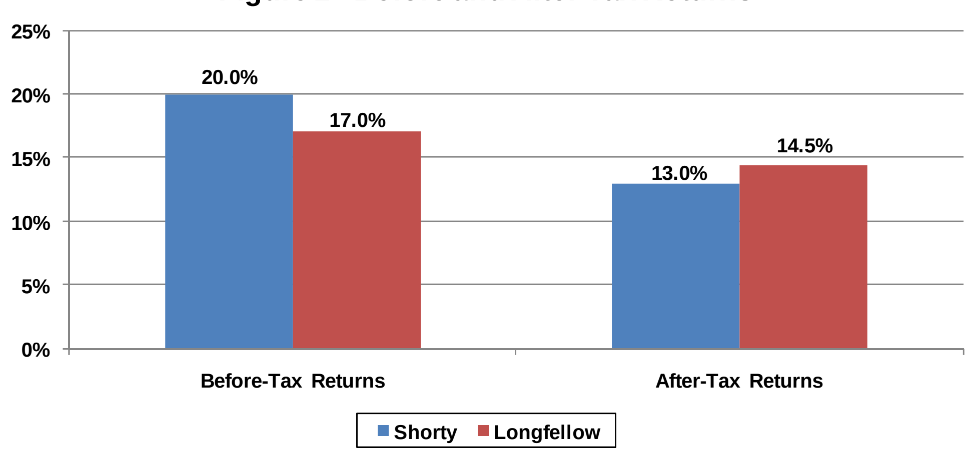
CURRENT TOPIC

Active Allocation and Taxes

Strategy

- *We increased exposure to high yield bonds for portfolios that have taxable bonds in their policy benchmarks.*
- *We purchased global equities to rebalance portfolios to current strategy.*
- *Portfolios remain modestly overweight developed market equity exposure and underweight bond exposure.*

Figure 1 - Before and After Tax Returns



Sources: Stairway Partners, Internal Revenue Service

"LONGFELLOW'S RESULTS ARE BETTER DUE TO THE FAVORABLE TAX TREATMENT GIVEN TO LONG-TERM CAPITAL GAINS"

Active Allocation and Taxes - cont'd

"For taxable investors, these return estimates should include the anticipated tax consequences of income and capital gains or losses"

Figure 2 - Annualized Three Year Expected Returns (before and after taxes)

	US Equities	High Yield Bonds	Municipal Bonds
Principal Gain/(Loss)	8.5%	-4.1%	-2.7%
+ Income Return	2.4%	9.0%	3.2%
Before-Tax Return	**11.1%**	**4.6%**	**0.4%**
+ Tax Benefit/(Cost)	-1.7%	-2.2%	0.5%
After-Tax Return	**9.4%**	**2.4%**	**0.9%**

and after-tax returns for two investors with successful investment strategies. In this example, a short-term investor (Shorty) sold an investment that had appreciated by 20% after holding it for 11 months. A long-term investor (Longfellow) sold an investment that had appreciated by 17% after holding it for 13 months. Based on market movement alone, Shorty had a better investment strategy. However, if both investors are required to pay taxes, Longfellow's results are better, due to the favorable tax treatment given to long-term capital gains. This simple example illustrates the benefit to taxable investors of maintaining an investment horizon of at least one year.

Taxes and Near-Term Returns

Over the long-term, we assume that equity investments produce a large portion of their returns through capital gains, and that bonds produce all of their returns through income. As a result, taxes reduce returns for taxable investors as income is paid and investments are eventually sold at higher prices. No asset class that we analyze is expected to produce capital losses in the long-term. Indeed, if such an asset class existed, it would surely have difficulty attracting investors and would soon become extinct.

Over shorter time periods, changing market conditions can produce significant price movements which in-turn can produce capital losses. These capital losses provide some benefit to taxable investors as they can be used to offset capital gains on other investments or a limited amount of income.

Active investors make decisions using forward looking return estimates. For taxable investors, these return estimates should include the anticipated tax consequences of income and capital gains or losses. Figure 2 illustrates this concept using three examples taken from our current expected returns, which are shown on page 4.

The first example shows US equities, which are expected to appreciate over a three year investment horizon. The resulting capital gains would be taxed in addition to the expected dividend income, producing lower after-tax returns. Current tax laws give favorable treatment to qualified dividends paid by US and many foreign corporations. As a result, the difference between the before and after-tax returns for US equities is relatively modest, especially when compared to the 11.1% expected total return.

The second example shows high yield bonds, where taxes have a more dramatic effect due to the high percentage of total return that comes from coupon income. There is a tax benefit from capital losses which are anticipated over the three year investment horizon, resulting from defaults and a modest increase in yields. However, this tax benefit is more than offset by the taxes paid on coupon income. In total, taxes reduce the annualized expected return from 4.6% to 2.4% for investors in the highest marginal tax bracket.

The third and final example shows municipal bonds, where the tax-exempt status of income leaves capital gains or losses as the only source of differentiation between before and after-tax returns. We expect municipal bond yields to move modestly higher over the next three years, which will result in capital losses. These losses will provide a benefit to taxable investors, which actually makes the expected return for municipal bonds higher on an after-tax basis.

Although it is difficult to quantify, the tax benefit of capital losses is not entirely symmetrical with the tax cost of capital gains. This is because there is no limit on the capital gains that can be taxed in a given year, where as

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Sources: Stairway Partners, Internal Revenue Service

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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capital losses beyond $3,000 can only benefit investors if they offset realized gains taken in the same year. Even though unused losses can be carried forward to offset future gains, their value is reduced over time.

Hedging and Taxes

Many investors purchase risky assets to capture higher returns, but implement hedging strategies in an effort to reduce the overall volatility or the risk of short-term losses. This hedging is often done for portfolios that contain equities or assets that have exposure to foreign currencies. Unfortunately for taxable investors, the relatively short life of many hedges can make some or all of their return subject to the higher tax rates associated with short-term gains and income, which detracts from overall after-tax returns.

Figure 3 uses Euro denominated bonds to illustrate the tax effects to a US investor of hedging the currency risk associated with a long-term foreign asset. This strategy is relatively common for investors who want to take advantage of higher yields abroad, without being subjected to the volatility associated with foreign currencies. In our example, the bond yield remains stable but the Euro depreciates, leaving the overall bond position with a capital loss. Because of the difference in the tax rates applied to long and short-term capital gains and losses, a currency hedge that fully offsets anticipated depreciation on a before-tax basis will most likely fail to do so, on an after-tax basis. In this case, tax inefficiency reduces after-tax returns by 3.4%. As a result, a taxable investor would need yields to be significantly higher in Europe to justify the hedged position.

Conclusion

Taxation can materially change the relative attractiveness of investments for different investors. This is why our active strategies sometimes differ based on the tax status of the underlying portfolios. Even though after-tax returns can be difficult to measure, we believe that this differentiation helps us to provide better investment results to clients with taxable portfolios.

To better communicate the analysis behind our active strategies, we are now publishing expected returns for the markets that we follow on a before and after-tax basis. This information is available on the last page of this publication and on the Stairway Partners' website.

Figure 3 - After-Tax Currency Hedge Effectiveness

	Bond Price (in Euros)	Exchange Rate ($/Euro)
Beginning Value	100.0	1.45
Ending Value	100.0	1.20
Change	0.0	-0.25

	Bond Value (with currency)	Currency Hedge	Total
Before-Tax Profit/(Loss)	-17.2%	17.2%	**0.0%**
+ Tax Benefit/(Cost)	2.6%	-6.0%	-3.4%
After-Tax Profit/(Loss)	-14.7%	11.2%	**-3.4%**

Sources: Stairway Partners, Internal Revenue Service

"The relatively short life of many hedges can make some or all of their return subject to the higher tax rates associated with short-term gains and income"

3 Year Annualized Return Estimates for Global Markets

9/1/2011	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**11.1%**	**4.1%**	**7.1%**	**9.4%**	**3.9%**	**5.6%**
Non-US Developed Markets	**17.6%**	**4.6%**	**13.0%**	**14.9%**	**4.4%**	**10.6%**
EMU	24.7%	4.9%	19.7%	21.0%	4.7%	16.3%
UK	23.7%	4.9%	18.8%	20.1%	4.7%	15.4%
Japan	9.8%	5.0%	4.8%	8.3%	4.8%	3.5%
Canada	-7.5%	4.3%	-11.8%	-6.3%	4.2%	-10.5%
Emerging Markets	**14.1%**	**5.8%**	**8.3%**	**11.4%**	**5.6%**	**5.7%**
Fixed Income						
US Aggregate	**-0.9%**	**2.1%**	**-3.0%**	**-1.4%**	**1.9%**	**-3.3%**
US Treasuries						
2 Year	-0.4%	0.9%	-1.2%	-0.7%	0.7%	-1.3%
5 Year	-3.1%	1.4%	-4.5%	-3.1%	1.2%	-4.3%
10 Year	-4.8%	1.9%	-6.7%	-4.6%	1.7%	-6.3%
30 Year	-5.6%	2.0%	-7.7%	-5.4%	1.8%	-7.2%
TIPS						
5 Year	-1.7%	1.4%	-3.2%	-2.0%	1.2%	-3.2%
10 Year	-4.1%	1.9%	-6.1%	-4.1%	1.7%	-5.8%
30 Year	-9.4%	2.3%	-11.7%	-8.4%	2.1%	-10.5%
Municipal	**0.4%**	**1.4%**	**-1.0%**	**0.9%**	**1.2%**	**-0.4%**
2 Year	0.1%	0.8%	-0.7%	0.3%	0.6%	-0.3%
5 Year	-1.2%	1.1%	-2.3%	-0.7%	0.9%	-1.6%
10 Year	-1.1%	1.6%	-2.6%	-0.4%	1.4%	-1.7%
20 Year	2.0%	1.8%	0.2%	2.3%	1.6%	0.7%
High Yield	**4.6%**	**3.0%**	**1.6%**	**2.4%**	**2.8%**	**-0.5%**
High Quality High Yield	4.1%	2.2%	1.9%	2.1%	2.0%	0.1%
Emerging Market ($ demonimnated)	**-0.2%**	**3.2%**	**-3.4%**	**-1.3%**	**3.0%**	**-4.3%**
Foreign Aggregate	**-5.1%**	**3.5%**	**-8.6%**	**-4.8%**	**3.3%**	**-8.1%**
Foreign Aggregate (hedged)	-2.4%	1.8%	-4.2%	-3.1%	1.6%	-4.7%
Foreign Treasury	**-5.4%**	**3.0%**	**-8.4%**	**-5.0%**	**2.8%**	**-7.8%**
Foreign Treasury (hedged)	-2.8%	1.4%	-4.2%	-3.4%	1.2%	-4.5%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-4.2%	2.3%	-6.5%			
British Pound	-1.8%	2.2%	-4.0%			
Japanese Yen	-2.1%	2.4%	-4.5%			
Canadian Dollar	-2.7%	1.4%	-4.1%			

Notes

1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and can be realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
   - 35.0% Ordinary Income, 15.0% Qualified Income, 0.0% Exempt Income, and 15.0% Capital Gains/(Losses)