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MONTHLY

VOLUME 7, ISSUE 10 OCTOBER 2010

VALUATION DRIVES EQUITY RETURNS

Introduction

The credit crisis that began in 2007, and the subsequent negative returns of 2008 and the first quarter of 2009 were responsible for driving many investors out of the equity market. Even though credit conditions have improved dramatically and the equity market has produced strong returns since the first quarter of 2009, many investors still choose to remain on the sidelines. This migration away from equities has been well documented in the press and can be observed in data provided by the Investment Company Institute (ICI). Figure 1 shows that net purchases of domestic equity funds turned negative on a year over year basis in March of 2007 and have remained negative ever since. ICI and Federal Reserve data indicates that the majority of the money that left the US Equity market ended up in cash and domestic bond funds.

As time goes on, investors are realizing that the low yields available in bond funds and traditional cash investments are not sufficient to meet their long-term return objectives. Instead of returning to long-term asset allocation strategies which include equities, many investors are turning to alternative investments and short-term trading strategies. We believe that part of the reason why so many investors have given up on equities is that the media focuses on negative market sentiment and backward looking economic statistics when assessing the outlook for equity market returns.

In this *Monthly*, we review our valuation framework for equities and examine the effectiveness of fundamental valuation factors and other commonly used indicators as predictors of future market returns.

Fundamental Equity Valuation

At the heart of any fundamental investment process is the intrinsic value of an asset, which is a function of the asset's ability to produce income. Investors use this framework to analyze the value of individual companies, because a company's ability to produce earnings and pay dividends ultimately

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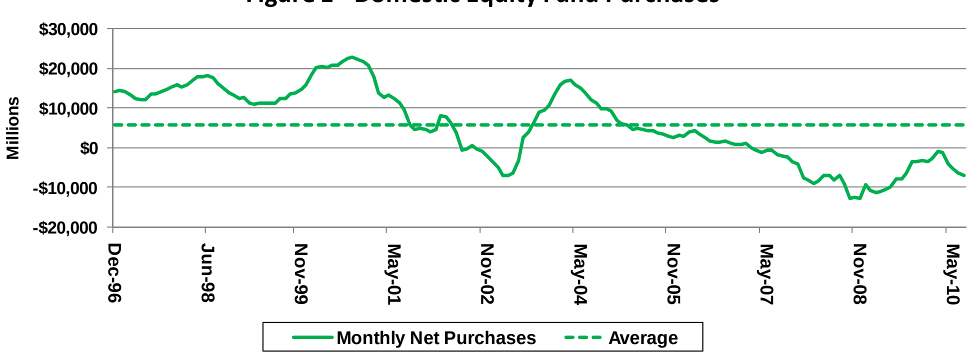
Figure 1 - Domestic Equity Fund Purchases



Sources: Investment Company Institute (ICI), Stairway Partners

CURRENT TOPIC

Valuation Drives Equity Returns

STRATEGY

- *We made no strategy changes during the month of September.*
- *Portfolio strategies remain overweight developed equity markets and underweight bond exposure.*

"EVEN THOUGH CREDIT CONDITIONS HAVE IMPROVED DRAMATICALLY AND THE EQUITY MARKET HAS PRODUCED VERY STRONG RETURNS SINCE THE FIRST QUARTER OF 2009, MANY INVESTORS CHOOSE TO REMAIN ON THE SIDELINES"

Valuation Drives Equity Returns - Cont'd

determines the price that a rational investor would be willing to pay for it. As fundamental investors, we look at markets in the same way.

Our equity valuation model is based on estimates of future corporate earnings. We believe that the best predictors of these future earnings are observable trends in past earnings and forward looking estimates of sustainable economic growth. Figure 2 illustrates how our estimated long-term trend compares to the actual earnings that have been reported by the companies in the S&P 500. The figure shows that although corporate earnings can be quite volatile, over the long-run they follow a path that has been consistent with real growth between 2 ½ and 3%.

Our April 2010 *Monthly* gives a detailed description of how earnings trends are calculated and used in our valuation of equity markets. The expected returns that are available on the Stairway Partners website and in this publication are derived from a cash-flow discounting process that uses these earnings forecasts, along with dividend payout, cash rate, and risk premium estimates.

Observing Fundamentals

Like any robust valuation framework, ours incorporates many forward looking assumptions. Unfortunately, these assumptions are not available historically, which makes observing the performance of fundamental valuation metrics as predictive indicators very difficult. As a result, we have simplified our framework in order to observe how fundamental earnings based valuation metrics perform as predictors of future market returns.

The metric that we use in our analysis is the ratio of market price of the S&P 500 to the aggregated operating earnings of the companies in the index (P/E ratio). Although earnings are generally reported on a quarterly basis, we will use annual earnings to eliminate seasonality and some of the very short-term reporting volatility.

To illustrate the benefits of using more stable trend earnings, we have also calculated a second P/E ratio using the trend earnings series described earlier and shown in figure 2. The P/E ratio based on our long-term trend analysis better matches the fundamental valuation process used to set strategy in Stairway Partners portfolios. Both of these P/E ratios are purely objective and are constructed using observable data, which allows us to track their historical performance.

Predictive Power of Valuations

To determine how well fundamental valuation metrics like P/E ratios perform as predictors of future returns, we compared the values of P/E ratios for the S&P 500 to the market returns that immediately followed each observation.

To quantify the results, we use a statistical tool known as regression analysis to produce a measure known as the R-Squared. The R-Squared describes how well an independent variable (P/E Ratio) predicts the value of a dependent variable (Future Market Returns). The R-Squared is always between 0% and 100%. In this study, a value of 100% indicates that all of the equity market's performance can be predicted by the in-going P/E Ratio. A value of 0% indicates that the P/E ratio has no value in predicting future market returns. For our analysis we used over 40 years of historical data, which covers 1970 through the first half of 2010.

Figure 3 shows the relationship between our two P/E ratios and the one, three and five year subsequent market returns. ***As expected, in every instance lower P/E ratios preceded higher market returns.*** There were

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Figure 2 - S&P 500 Earnings

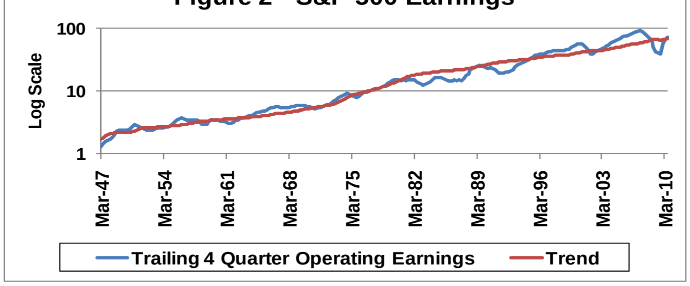
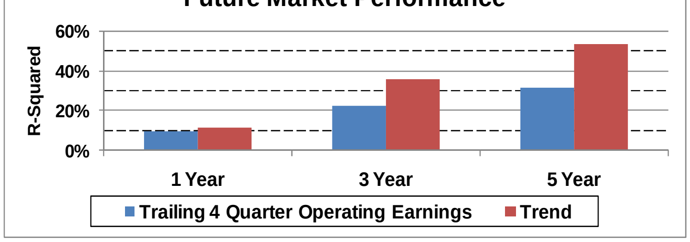


Figure 3 - Predictive Power of P/E Ratios to Future Market Performance



"THE PREDICTIVE POWER FOR BOTH OF THE FUNDAMENTAL VALUATION FACTORS INCREASED AS THE INVESTMENT HORIZON INCREASED"

Sources: Standard & Poor's, 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.

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two other important conclusions that could be drawn from the study. Firstly, in all three time periods, the trend earnings based P/E ratio did a better job of predicting future returns than the trailing four quarter earnings based P/E ratio. Secondly, the predictive power for both of the fundamental valuation factors increased as the investment horizon increased. This reinforces our belief that fundamental investment analysis works best for investors with longer time horizons.

Fundamentals versus Other Factors

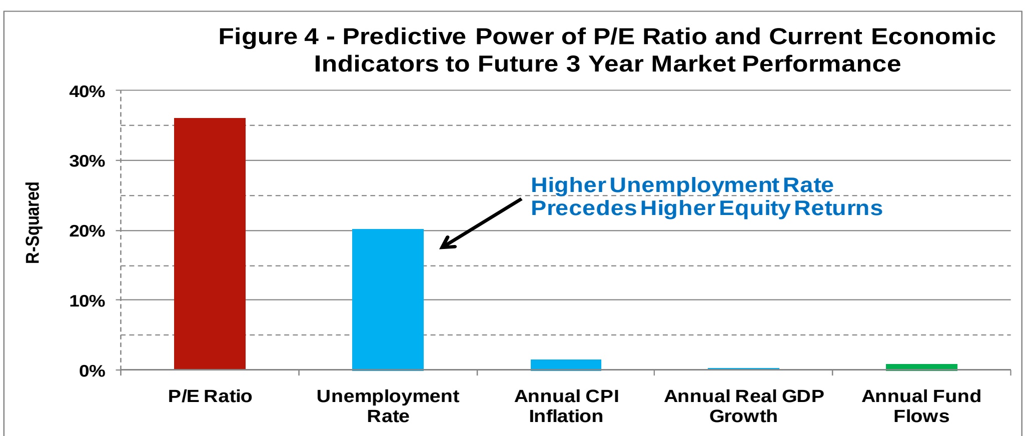
The case to abandon equities is often based on the level of near-term economic or market indicators. In the current environment, it is difficult to turn on a radio or television, or read a newspaper without being confronted with negativity about the state of the global economy and investor sentiment.

To illustrate that current economic statistics are not good predictors of future market returns, we used the same technique as above to look at how well several commonly used indicators do in predicting the return of the S&P 500 in the following 3 years.

Figure 4 shows how our fundamental indicator compares to the unemployment rate, annual CPI Inflation, annual real GDP growth, and annual mutual fund flows in terms of their ability to predict future equity market returns. In our study, the valuation based P/E ratio did the best job of predicting stock market returns over the past 40 years. The only other factor that produced meaningful results was the unemployment rate. ***However, contrary to conventional wisdom, a higher unemployment rate preceded periods of higher equity market returns.*** This is because employment tends to be a lagging indicator, and often turns after markets begin to look toward the other side of the business cycle.

Conclusion

The financial crisis that began in 2007 drove many investors out of the equity market. Negative sentiment, reinforced by the media, has kept many of those investors on the sidelines, even as market conditions have improved. Many indicators of current economic conditions and investor sentiment remain cautionary, but historically these have been poor predictors of equity market returns. Valuation based metrics have had a much better track record as leading indicators. The trend based P/E ratio for the S&P 500 that we used in our analysis is close to its historical average for a 40 year period where equities produced annualized returns of roughly 9½%. This output is consistent with our overweight to US equities.



Sources: Standard & Poor's, US Bureau of Labor Statistics, ICI, Stairway Partners

"THE VALUATION BASED P/E RATIO DID THE BEST JOB OF PREDICTING STOCK MARKET RETURNS OVER THE PAST FORTY YEARS"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	14.0%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	26.1%	5.6%		
Japan	4.6%	3.8%		
UK	27.9%	5.9%		
Emerging	3.6%	10.7%	neutral	Asset class close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, other sectors offer better value
2-Year	0.2%	1.9%		
5-Year	0.0%	2.5%		
10-Year	0.4%	3.2%		
30-Year	2.2%	3.9%		
US Municipal Bonds			under	In longer maturities, municipal bonds are close to fair value
2-Year	0.4%	1.5%		
5-Year	0.7%	2.0%		
10-Year	2.1%	2.7%		
30-Year	8.2%	3.6%		
US High Yield	5.8%	3.7%	over	Attractive relative to other fixed income sectors
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	-0.4%	3.4%		
Japan 10-Year	0.1%	1.2%		
UK 10-Year	0.1%	3.9%		
Emerging Markets Debt	1.7%	3.9%	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	-4.7%	21.5%	-5.0%	Euro above fair value
Japanese yen	-2.3%	2.3%	-2.2%	Yen is near fair value
UK pound	-1.7%	26.1%	-1.6%	Pound is near fair value

Notes: **As of: September 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.