STAIRWAY PARTNERS, LLC

2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

MONTHLY

VOLUME 9, ISSUE 10 OCTOBER 2012

EARNINGS AND ECONOMIC ACTIVITY

Introduction

At Stairway Partners, we have always taken a long-term approach to evaluating markets, based on the fundamental factors which we believe will generate returns for investors over time. For equities, corporate earnings play a crucial role in our valuation process, since they are the ultimate source of the cash-flows which come in the form of dividends.

Without such a valuation framework, investors often must rely on fleeting news headlines, which may not reflect the conditions that will drive future market returns. These headlines not only have the ability to influence people's expectations about the future, but surprisingly they can also influence their perceptions of the past. Franklin Templeton recently surveyed 1,000 investors about their recollection of equity market returns. 66% of the investors surveyed believed that the S&P 500 declined in 2009, when it actually gained a more than healthy 26.5%. 48% of the investors also thought that the S&P 500 declined in 2010 and 53% thought that it declined in 2011. The S&P 500 actually produced positive returns of 15.1% and 2.1% respectively in those years.

In this *Monthly* we review the link between corporate earnings and economic activity, discuss how globalization impacts the growth potential across markets, and examine the current state of global earnings.

Domestic GDP and Earnings Growth

Corporate earnings are tied directly to economic activity, because they are the result of goods and services being purchased by businesses and consumers. As a result, broad measures of economic growth can help to explain and predict the ability of companies to increase their earnings over time. Figure 1, which should look familiar to our regular readers, shows the stable long-term relationship between economic output in the United States and the profits generated by domestic companies. Since the end of World War II, gross domestic product (GDP) and corporate profits have both grown at roughly a 7% rate, due to a consistent increase in both real activity and inflation. The figure also illustrates that over shorter time

(Continued on page 2)

CURRENT TOPIC

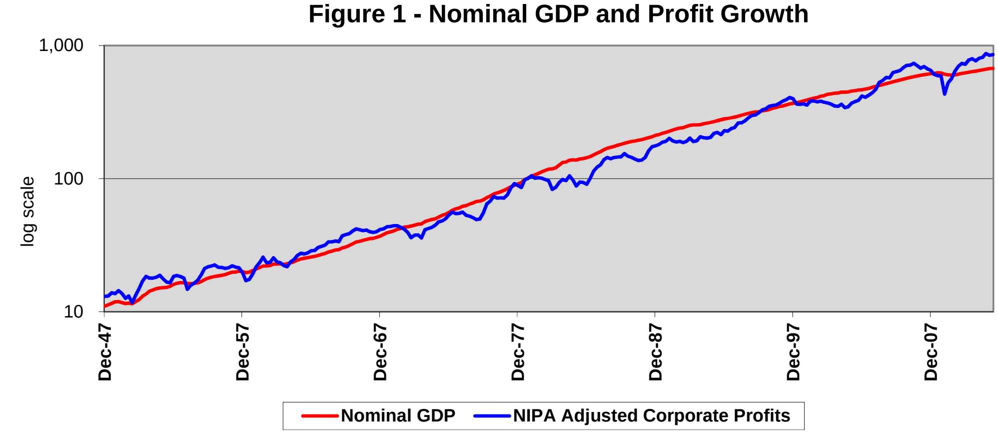
Earnings and Economic Activity

- *Introduction*
- *Domestic GDP and Earnings Growth*
- *Global Growth and Earnings*
- *Current Earnings and Market Valuation*
- *Conclusion*

Strategy

- *We made no strategy changes during the month of September.*
- *Portfolios remain overweight global equity exposure and underweight investment grade bond exposure.*

Figure 1 - Nominal GDP and Profit Growth



Sources: US Bureau of Economic Analysis, Stairway Partners

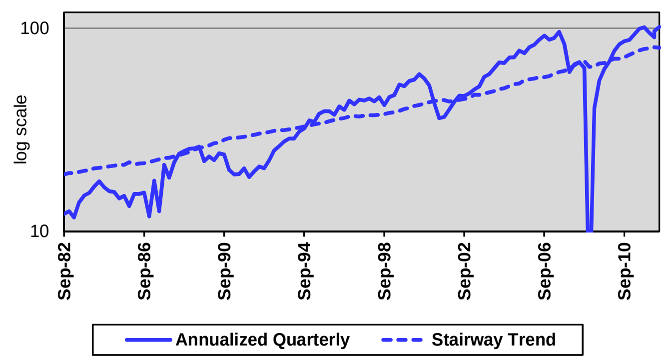
EARNINGS AND ECONOMIC ACTIVITY - CONT'D

periods corporate profits have been considerably more volatile than GDP.

Although earnings are a key component of fundamental equity market valuations, short-term fluctuations in reported numbers can make it difficult for investors to determine the ongoing profitability of corporations. At Stairway Partners, we look through the short-term volatility of earnings and base our investment decisions on the longer-term trends, which are persistent and observable. Figure 2 illustrates that the quarterly operating earnings for the S&P 500 have dramatically deviated from our trend, only to return over time.

Our longer-term focus was particularly helpful in managing equity exposure through the financial crisis, where S&P 500 operating earnings were extremely volatile and included the first and only negative quarter in the history of the data series. Many investors without a long-term perspective were led astray by ignoring the trend and extrapolating strong earnings in 2007 or negative earnings in the first quarter of 2009.

Figure 2 - S&P 500 Operating Earnings



"QUARTERLY OPERATING EARNINGS FOR THE S&P 500 HAVE DRAMATICALLY DEVIATED FROM OUR TREND, ONLY TO RETURN OVER TIME"

Global Growth and Earnings

Because many companies produce and sell their products outside of their home country, global business conditions have a profound impact on corporate earnings within regional and country-specific equity markets. Automobile manufacturers provide a good example of companies that exist within a given country's equity market, but operate globally. Figure 3 shows the geographic distribution of 2011 vehicle sales for three of the largest global producers of automobiles, Ford of the United States, Toyota of Japan, and Volkswagen of Germany. The figure illustrates that although all three of these global manufacturers have their largest market exposure within their domestic region, they also have roughly half of their exposure in other parts of the world. As a result, their earnings will be meaningfully impacted either positively or negatively by economic conditions outside of the country in which they report their results.

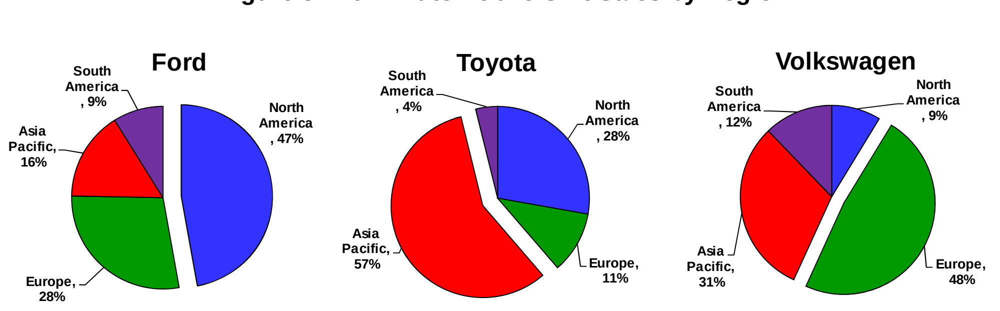
Between developed markets that have similar long-term growth rates, this international exposure provides diversification benefits, but does little to alter the long-term relationship between domestic GDP and earnings growth. However, when companies have exposure to markets with different long-term growth rates, corporate earnings can deviate from domestic GDP growth over longer time periods. This can be seen in figure 4, which shows that the long-term earnings growth rates for companies in developed markets have been consistently higher than their domestic rates of GDP growth. A likely contributor to the difference is that companies domiciled in developed markets have benefitted from the higher real growth rates experienced in emerging market countries, where they do business.

Current Earnings and Market Valuation

There are times when broad

(Continued on page 3)

Figure 3 - 2011 Automobile Unit Sales by Region



Sources: Standard & Poor's; Ford, Toyota, and Volkswagen 2011 annual reports; 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.

(Continued from page 2)

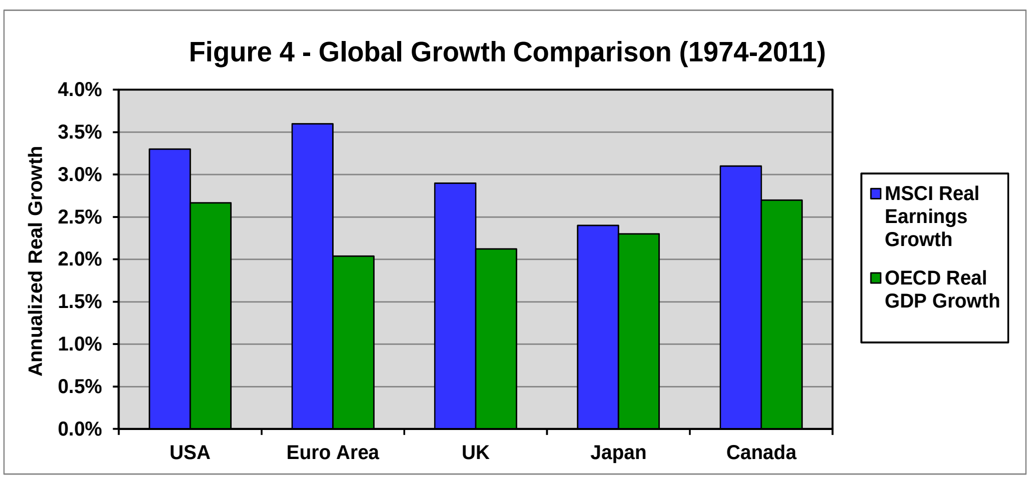
global events are significant enough to overwhelm local factors and drive earnings across markets. This was the case in the most recent global recession, and to some extent in the recovery that followed. We illustrated this point the last time that we provided an update on corporate earnings in the June 2011 *Monthly*.

Currently, there are several interesting themes that can be observed in the operating earnings of global equity markets relative to their underlying trends. Earnings in the US are roughly 15% above their historical trend, and we expect them to decline modestly over a three-year horizon. This relationship can be seen in figure 2. Using the same framework, Emerging market and UK earnings are currently close to their historical trends. As a result we expect earnings in those markets to increase at their respective long-term growth rates over time. Canadian earnings are 30% above trend, which may be attributable to the benefits of the country's large commodity exposure and the relative health of Canada's financial sector. European earnings are roughly 25% below trend as a result of the ongoing debt crisis, and the austerity measures which have been implemented in some countries. Finally, Japan's earnings are 30% below trend, which is partially due to the lingering effects of the 2011 earthquake and tsunami that disrupted manufacturing and the country's nuclear power industry.

Although corporate earnings are a critical component of our valuation process and are the focus of this report, they are not the sole determinant of expected returns. The expected returns that we calculate and publish on the last page of this report are based on the discounted cash flows that come from our projected earnings, and current market prices. Often it is not a discrepancy in earnings forecasts that leads to market opportunities, but rather a discrepancy in the price that investors are willing to pay for projected earnings. Monitoring the components of return helps us to better understand the market and make informed investment decisions.

Conclusion

Avoiding the the pitfalls of investing based on short-term headlines requires a disciplined investment process. For equity markets, we believe that long-term earnings trends are the ultimate source of value for investors over time. Without an understanding of these trends, it is difficult to put volatile market prices and current earnings into perspective.



"COMPANIES DOMICILED IN DEVELOPED MARKETS HAVE BENEFITTED FROM THE HIGHER REAL GROWTH RATES EXPERIENCED IN EMERGING MARKET COUNTRIES"

Sources: MSCI, the Organisation for Economic Co-operation and Development (OECD), Stairway Partners

3 Year Annualized Return Estimates for Global Markets

10/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**8.4%**	**4.0%**	**4.4%**	**7.1%**	**3.8%**	**3.3%**
Non-US Developed Markets	**19.2%**	**4.5%**	**14.7%**	**16.3%**	**4.3%**	**12.0%**
EMU	27.0%	4.9%	22.1%	22.9%	4.7%	18.2%
UK	24.4%	4.8%	19.6%	20.7%	4.6%	16.0%
Japan	11.6%	4.9%	6.7%	9.9%	4.8%	5.1%
Canada	-2.9%	4.3%	-7.2%	-2.5%	4.1%	-6.6%
Emerging Markets	**20.1%**	**5.7%**	**14.3%**	**16.8%**	**5.6%**	**11.2%**
Fixed Income						
US Aggregate	**-1.7%**	**2.0%**	**-3.8%**	**-2.0%**	**1.9%**	**-3.9%**
US Treasuries						
2 Year	-0.1%	0.8%	-0.9%	-0.3%	0.6%	-1.0%
5 Year	-2.6%	1.3%	-3.9%	-2.6%	1.1%	-3.7%
10 Year	-5.7%	1.8%	-7.5%	-5.2%	1.7%	-6.9%
30 Year	-9.3%	2.0%	-11.3%	-8.3%	1.8%	-10.1%
TIPS						
5 Year	-2.2%	1.4%	-3.5%	-2.2%	1.2%	-3.4%
10 Year	-6.5%	1.9%	-8.4%	-5.9%	1.8%	-7.7%
30 Year	-14.8%	2.3%	-17.1%	-12.6%	2.1%	-14.7%
Municipal	**-0.8%**	**1.4%**	**-2.2%**	**-0.2%**	**1.2%**	**-1.4%**
2 Year	0.1%	0.7%	-0.6%	0.3%	0.5%	-0.3%
5 Year	-1.4%	1.1%	-2.5%	-0.9%	0.9%	-1.8%
10 Year	-2.1%	1.5%	-3.6%	-1.3%	1.3%	-2.7%
20 Year	-0.2%	1.7%	-1.9%	0.4%	1.6%	-1.2%
High Yield	**1.9%**	**3.0%**	**-1.0%**	**0.4%**	**2.8%**	**-2.4%**
High Quality High Yield	1.8%	2.1%	-0.3%	0.4%	2.0%	-1.6%
Emerging Market ($ demonimnated)	**-1.5%**	**3.2%**	**-4.8%**	**-2.3%**	**3.0%**	**-5.3%**
Foreign Aggregate	**-4.8%**	**3.4%**	**-8.2%**	**-4.4%**	**3.3%**	**-7.7%**
Foreign Aggregate (hedged)	-3.4%	1.7%	-5.1%	-3.5%	1.6%	-5.1%
Foreign Treasury	**-4.8%**	**3.0%**	**-7.8%**	**-4.4%**	**2.8%**	**-7.2%**
Foreign Treasury (hedged)	-3.7%	1.3%	-5.0%	-3.7%	1.1%	-4.9%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Foreign Currency (versus US$)						
Euro	-2.8%	2.3%	-5.1%			
British Pound	-0.9%	2.2%	-3.1%			
Japanese Yen	0.1%	2.4%	-2.3%			
Canadian Dollar	-1.6%	1.4%	-3.0%			

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 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)