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MONTHLY

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TAX CHANGES AND INVESTMENT RETURNS

Introduction

Deficit spending can cause significant problems for a country, if investors' confidence in the government's ability to balance budgets over the long-term is shaken. Developments in some of the weaker members of the European Union over the past several years and the historic downgrade of the United States' credit rating in the middle of 2011 are stark reminders to this fact.

The United States government has produced uninterupted budget deficits since 2002, the largest of which have been seen in the last four years. The need to close the long-term gap between revenues and spending at the federal level is undisputed. Although the debate over the best way to balance the budget in Washington continues, we believe the most likely scenerio is that tax revenues will ultimately have to increase over time. The form that tax increases might take and the timing of when they would be implemented is still unknown, but we expect greater clarity after next week's elections.

In the May 2010 Monthly – "Taxes and Investment Returns" we wrote about what were then thought to be imminent tax changes. Subsequent economic and political events changed the discussion and pushed the tax increases that were expected to take effect in 2011 back to 2013 or later. The Medicare tax, which was passed as part of the health care reform bill, is still scheduled to take effect at the beginning of next year.

Interestingly, after two years of debate, we believe that the most likely outcome has not changed materially. In this *Monthly,* we refresh our assumptions about the most likely changes to the federal tax code and analyze the impact that these changes would have on investment returns, for those in the highest tax brackets.

Taxes on Income

The current tax rates on income are the result of temporary reductions, which were put in place by President George W. Bush in 2003. These reductions have remained in place longer than originally intended due to several extensions, which were granted to help combat the last recession, financial crisis, and the subsequent anemic recovery. Under the current tax structure, those with income in the highest

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CURRENT TOPIC

Tax Changes and Investment Returns

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Strategy

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

Figure 1 - Potential Tax Rate Changes

		--- 2013 --- *	
	Current	No Action (Fiscal Cliff)	Expected
Investment Income (top bracket)	35.0%	43.4%	43.4%
Qualified Dividends	15.0%	43.4%	23.8%
Long-Term Capital Gains	15.0%	23.8%	23.8%
Municipal Bond Interest	0.0%	0.0%	0.0%

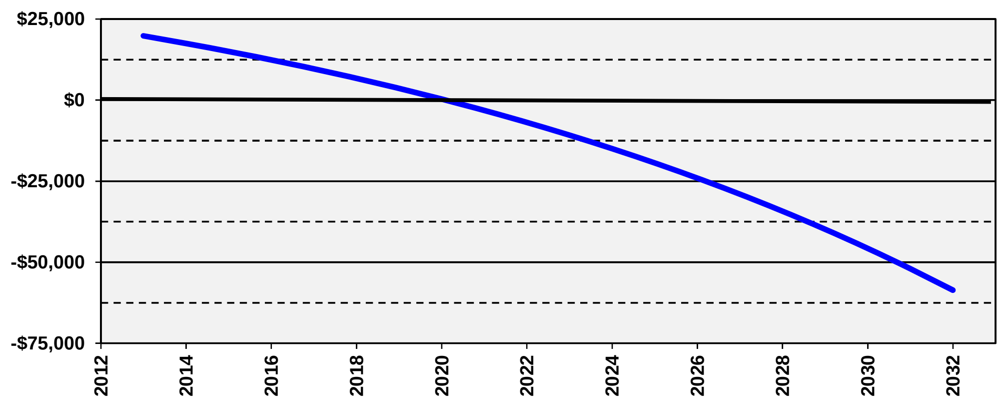
Sources: Stairway Partners, Office of Management and Budget

* 2013 estimates include 3.8% Medicare tax.

TAX CHANGES AND INVESTMENT RETURNS - CONT'D

"THE EFFECTS OF NOT SELLING AND ALLOWING ACCUMULATED GAINS TO COMPOUND OUTWEIGH THE BENEFIT OF SELLING EARLY AND PAYING THE LOWER TAX RATE AFTER EIGHT YEARS"

Figure 2 - Benefit of Selling Before 2013 Tax Increase



tax bracket pay a marginal rate of 35%. Although it is possible that headline tax rates will fall and revenues will be made up by severely reducing exemptions, we expect the top marginal tax rate to revert back to the 39.6% level that existed before the temporary tax cuts. If no action is taken between now and the end of the year, this increase will occur as part of the "fiscal cliff". The interest paid on taxable bond and cash investments is considered ordinary income and is taxed along with other earnings. Several other types of investment income have historically been given favorable tax treatment, including municipal bond interest and stock dividends.

The majority of debt issued by state and local governments is exempt from federal taxation, and as a result is immune to changes in marginal tax rates.

We assume that municipal bond interest will continue to be exempted from federal taxes, but there is a chance that this could change to facilitate lower headline tax rates. It is also possible that a minimum aggregate tax rate could be imposed, which could negate some of the benefits of tax-free municipal bond interest for wealthy investors. We do not believe that these changes will occur in 2013.

Dividends paid by most companies qualify for special treatment and are taxed at the 15% long-term capital gains rate. Effectively, all dividends paid by US and other developed market companies are considered qualified. Roughly 60% of the dividends paid by emerging market companies are considered qualified. We expect qualified dividends to continue to be taxed like long-term capital gains, but that the tax rate on long-term gains will increase to 20%. Figure 1 summarizes our estimates of the most likely federal tax rate changes.

Taxes on Capital Gains

When investing in public markets, investors have little control over when they receive income. However, investors do have significant control over when they realize capital gains or losses, based on when investments are sold. Since taxes on realized capital gains can have a significant impact on retained profits, potential changes in tax rates should be considered when deciding whether to hold or to sell an

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Figure 3 - Long-Term Return Assumptions

	Before-Tax Returns	After-Tax Returns: Current	After-Tax Returns: Expected	After-Tax Returns: Difference
US Equities	8.2%	7.0%	6.3%	-0.7%
Developed Foreign Equities	8.0%	6.8%	6.1%	-0.7%
Emerging Market Equities	10.0%	8.3%	7.4%	-0.9%
US Core Bonds	5.5%	3.6%	3.1%	-0.5%
Municipal Bonds	4.0%	4.0%	4.0%	0.0%
Foreign Bonds	5.2%	3.4%	2.9%	-0.5%
High Yield Bonds	7.4%	4.8%	4.2%	-0.6%
Emerging Market Bonds	7.1%	4.6%	4.0%	-0.6%
Cash	4.2%	2.7%	2.4%	-0.3%

Source: 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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investment.

Investors may benefit from the early sale of an asset with unrealized long-term gains, if tax rates increase in the future. However, there are other factors, which can impact total returns, that should also be considered.

Figure 2 illustrates how the benefits of selling before an increase in tax rates changes over time for a $1 million portfolio with $250,000 of unrealized gains. We assume that long-term capital gains taxes increase from 15% to 23.8% in 2013, and that the asset continues to appreciate at a 6% annual rate. It is not surprising that there is a material benefit to selling in 2012 (before the tax rate increase) relative to selling in 2013 (just after the increase). However, the effects of not selling and allowing accumulated gains to compound over time eventually outweigh the benefit of selling early and paying the lower tax rate. In this example it is better to not sell in 2012, if the asset will be held for more than eight years.

Note: The preceeding analysis focuses on long-term gains, which result if investments are held for more than one year. Short-term gains are taxed at the much higher ordinary income rate, and as a result should be avoided to maximize after-tax returns.

After-Tax Total Returns

To determine the mix of assets which best suits the needs of a taxable investor, we use long-term estimates of both risk and after-tax returns. Therefore, our return estimates must be broken down into the components that affect taxation, such as capital gains, total income, and qualified or exempt income. The table in Figure 3 shows our long-term after-tax return estimates for the major asset classes based on current tax policies and on the expected policies shown in Figure 1.

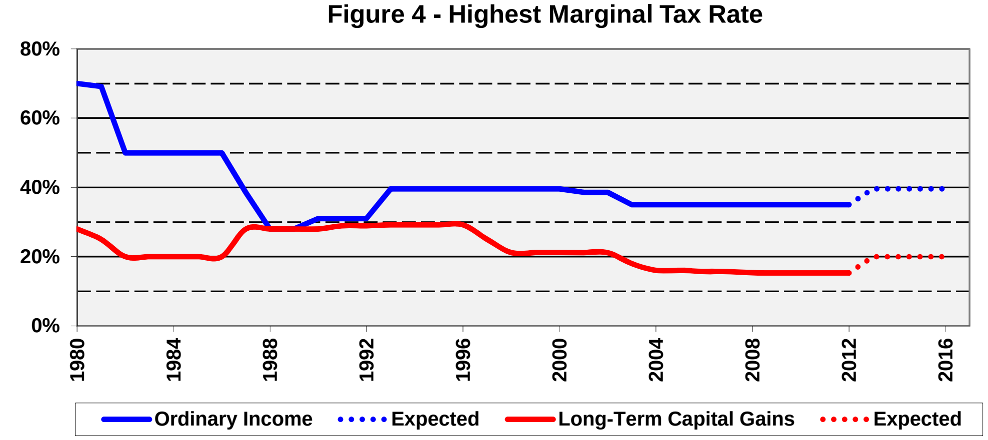
Since near-term market returns can deviate materially from long-term estimates, we calculate shorter term estimates of before and after-tax returns. These are always shown on the last page of this report. These shorter-term estimates, which take current market conditions into account, are used to guide our decisions around asset allocation strategies.

Conclusion

Tax policies change over time, and it is important to recognize the effects that they can have on the market returns that are retained by investors. Figure 4 shows how our expected changes to the top marginal income and long-term capital gains tax rates compare to past experience.

Making informed decisions can be complicated because of the uncertainty around future tax policies and market returns. However, having the proper framework in which to analyze future after-tax returns can help investors to understand the implications that near-term decisions have on their long-term results.

Figure 4 - Highest Marginal Tax Rate



Sources: US Treasury Office of Tax Analysis, Stairway Partners

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3 Year Annualized Return Estimates for Global Markets

11/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**10.3%**	**4.0%**	**6.3%**	**8.7%**	**3.8%**	**4.9%**
Non-US Developed Markets	**19.6%**	**4.5%**	**15.1%**	**16.6%**	**4.3%**	**12.3%**
EMU	26.8%	4.9%	22.0%	22.8%	4.7%	18.1%
UK	24.9%	4.8%	20.1%	21.1%	4.6%	16.5%
Japan	12.6%	4.9%	7.7%	10.6%	4.8%	5.9%
Canada	-2.1%	4.3%	-6.3%	-1.7%	4.1%	-5.8%
Emerging Markets	**20.8%**	**5.7%**	**15.1%**	**17.4%**	**5.6%**	**11.8%**
Fixed Income						
US Aggregate	**-1.8%**	**2.0%**	**-3.9%**	**-2.0%**	**1.9%**	**-3.9%**
US Treasuries						
2 Year	0.0%	0.8%	-0.8%	-0.3%	0.6%	-0.9%
5 Year	-2.4%	1.3%	-3.7%	-2.4%	1.1%	-3.6%
10 Year	-5.6%	1.8%	-7.4%	-5.2%	1.7%	-6.8%
30 Year	-9.1%	2.0%	-11.0%	-8.1%	1.8%	-9.9%
TIPS						
5 Year	-2.1%	1.4%	-3.4%	-2.1%	1.2%	-3.3%
10 Year	-6.6%	1.9%	-8.5%	-6.0%	1.7%	-7.7%
30 Year	-15.3%	2.3%	-17.6%	-13.0%	2.1%	-15.1%
Municipal	**-0.8%**	**1.4%**	**-2.1%**	**-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	-2.2%	1.5%	-3.6%	-1.4%	1.3%	-2.7%
20 Year	-0.2%	1.7%	-2.0%	0.4%	1.6%	-1.2%
High Yield	**1.9%**	**2.9%**	**-1.0%**	**0.4%**	**2.8%**	**-2.4%**
High Quality High Yield	1.8%	2.1%	-0.3%	0.4%	1.9%	-1.6%
Emerging Market ($ demonimnated)	**-1.8%**	**3.2%**	**-5.0%**	**-2.5%**	**3.0%**	**-5.5%**
Foreign Aggregate	**-3.9%**	**3.4%**	**-7.4%**	**-3.7%**	**3.3%**	**-7.0%**
Foreign Aggregate (hedged)	-3.4%	1.7%	-5.1%	-3.3%	1.6%	-4.9%
Foreign Treasury	**-3.9%**	**3.0%**	**-6.9%**	**-3.6%**	**2.8%**	**-6.5%**
Foreign Treasury (hedged)	-3.6%	1.3%	-4.9%	-3.5%	1.1%	-4.6%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**

Foreign Currency (versus US$)	Expected	Hurdle	Excess
Euro	-2.2%	2.3%	-4.6%
British Pound	-0.3%	2.2%	-2.5%
Japanese Yen	1.3%	2.4%	-1.1%
Canadian Dollar	-0.5%	1.4%	-1.9%

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)