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QUARTERLY

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CHOOSING THE RIGHT EQUITY ALLOCATION

Introduction

Those with money to invest often struggle with the decision on which assets to hold into their portfolio. Cash can be a safe alternative for investors who do not want to risk losing principal, but the low rate of interest paid on cash often fails to keep up with inflation. As a result, cash investors might look back to find that they did not lose any money, but that the actual value of their money has declined. That has certainly been the case over the past five years as cash rates have been close to zero and inflation has eroded the purchasing value of people's savings by close to 7%.

We believe that investors have a better chance of increasing the real value of their assets over time by investing in a balanced portfolio of stocks and bonds. Since research has repeatedly shown that the vast majority of a portfolio's return can be explained by its exposure to different asset classes, it is important that investors understand how exposure to these asset classes can impact the overall risk and return characteristics of their portfolios. In this *Quarterly*, we examine some of the most important factors that investors should consider as they determine the appropriate level of equity exposure and which equities to hold in their portfolios.

Overall Equity Exposure

In a well-diversified balanced portfolio containing equities, bonds, and cash, we believe that the total equity exposure is the most significant source of risk. The reason that equity weights are so important to overall risk within a balanced portfolio is that by most estimates, including our own, equities are four to five times riskier than most fixed income investments. This can be seen in Figure 1, which shows our long-term estimates of risk for the major equity markets, bonds, and cash. We are not unique in using total equity exposure as an indicator of overall portfolio risk. The mutual fund and investment consulting industries have also chosen to categorize balanced portfolios based on overall equity exposure. Funds with less than 50% equity exposure are generally categorized as conservative, funds with 70% or more equity exposure are categorized as aggressive, and funds with equity exposure between 50% and 70% equity exposure are categorized as moderate.

By combining cash and bonds with varying degrees of global equity exposure, investors can construct balanced portfolios with varying degrees of risk. Over long time periods, we expect portfolios with larger equity allocations to produce higher overall returns.

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CURRENT TOPIC

Choosing the Right Equity Allocation

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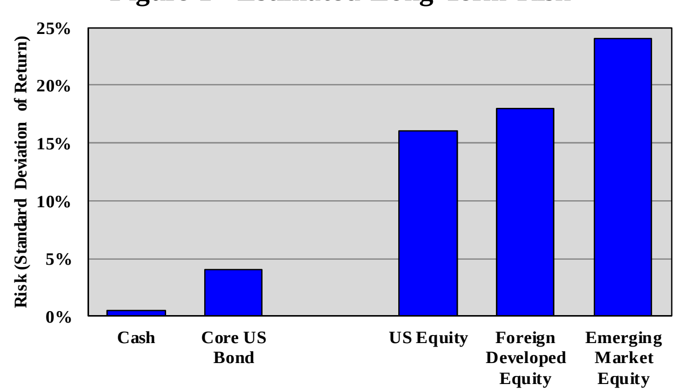
- *Conclusion*

Strategy

- *We did not make any material strategy changes during the third quarter.*
- *Portfolios remain overweight foreign equity exposure and underweight investment grade bond exposure.*

Figure 1 - Estimated Long-Term Risk



Source: Stairway Partners

CHOOSING THE RIGHT EQUITY ALLOCATION - CONT'D

Unfortunately, these higher returns are also expected to produce more risk for investors. Figure 2 illustrates this point by comparing the average compounded returns and the worst twelve month return periods for three different portfolios over the twenty five year period from 1988 through 2012. Looking back, as the equity weight increased, so did both the average annualized return over the full period and the loss in the worst twelve month period.

Market Capitalization

In the absence of other information, we believe that holding an equity portfolio that is weighted by market capitalization is a good alternative. This is based on the theory that if markets are efficient, then the collective judgment of all market participants should represent the best estimate of intrinsic value. Constructing a portfolio based on the market capitalization of the underlying companies also has the advantage of not requiring rebalancing. Avoiding the transactions associated with rebalancing reduces trading costs and can also reduce the tax liabilities that may result from capital gains on the sale of appreciated assets.

Many investors choose to sub-divide their equity portfolios based on the market capitalization (large, mid, or small cap) and style (growth or value) of the underlying companies. They do this because research has shown that these two factors can have a meaningful impact on performance. Although performance can vary along the lines of market capitalization and style, we do not believe that these differences are sufficient to warrant altering the weights of long-term equity allocations within a given market. As a result, we recommend using a broad benchmark which does not discriminate by market capitalization or style.

Figure 3 illustrates the market cap and style breakdown of the broad US equity market. Most index providers have chosen to divide equity markets in terms of style so that the weights of growth and value stocks are equal. However, because large-cap stocks are inherently bigger than small-cap stocks, they make up a much larger portion of the overall equity market. It is worth noting that although small-cap stocks carry a much lower weight in terms of overall market value, they outnumber large and mid-cap stocks by about two to one.

Considering International Equities

Although many companies have significant business exposure outside of their home markets, the country of domicile is most often used to categorize equities within market indices. Figure 4 breaks down the global equity market by geographic location, showing the US domestic equity market relative to the emerging and developed foreign markets. The figure illustrates that if an investor relied strictly on market capitalization, a global equity portfolio would have more than half of its value allocated outside of the United States.

Despite the previously mentioned theoretical attractiveness of a market capitalization weighted allocation to equities, there are a number of factors which could lead an investor to deviate from market implied weights. Specifically, we believe that the risk and return patterns of foreign equities vary significantly enough relative to domestic equities to justify altering their strategic allocation from the weights implied by market capitalization. This difference in return patterns can be observed in Figure 5, which shows the trailing twelve month returns for global equity markets.

Historically, equities of companies domiciled in emerging countries have been riskier than those in developed countries, including the United States. We believe that this pattern will persist, but that investors will be compensated over time for the relative riskiness of emerging market (EM) equities by the potential for higher returns. Because both

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Figure 2: Total Returns (1988 through 2012)

	Conservative	Moderate	Aggressive
Average	8.3%	8.7%	9.2%
Worst 12 Months	-22.7%	-29.9%	-36.5%

Figure 3: US Equity Market Composition

		Style	
		Value	Growth
Market Capitalization	Large / Mid	43%	43%
	Small	7%	7%

Sources: MSCI, Russell, Bloomberg, Stairway Partners

About Stairway Partners, LLC

Stairway Partners was formed to provide ourselves and our clients with an effective and comprehensive solution for managing wealth, over the long-term. 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. All of our portfolios utilize customized investment policies to align portfolio objectives with our investment strategy utilizing the global capital markets.

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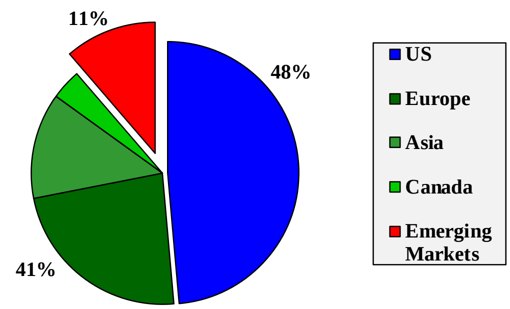
the risk and return of EM equities are commensurately higher than developed market equities, we believe that the level of EM equities in a given portfolio should be based on the investors overall return objectives and tolerance for risk. Higher EM equity weights are appropriate for more aggressive portfolios.

In contrast to EM equities, the equities of companies in foreign developed countries have underlying market characteristics that are largely similar to those of US companies. However, since foreign equities have market prices and income denominated in foreign currencies, they are riskier from the perspective of US investors. This is because movements in foreign exchange rates can have a significant impact (positive or negative) on overall returns. Although US investors benefit from the diversification provided by the returns of underlying foreign equity markets and their respective currencies, they may not be adequately compensated for the volatility associated with currency fluctuations. Unlike underlying asset markets which must compensate all investors for higher risk, currency risk only exists from the perspective of foreign investors. As an example, the Euro exposure that comes from owning shares of Volkswagon represents additional risk to a US investor whose expenses are denominated in dollars, but not to a German investor who uses Euros to pay for his morning coffee. The total impact of this uncompensated currency risk is sufficient to reduce the amount foreign developed equities that we recommend for US investors, but not nearly enough to eliminate the asset class from a well-diversified balanced portfolio.

Figure 4: Global Equity Market Composition

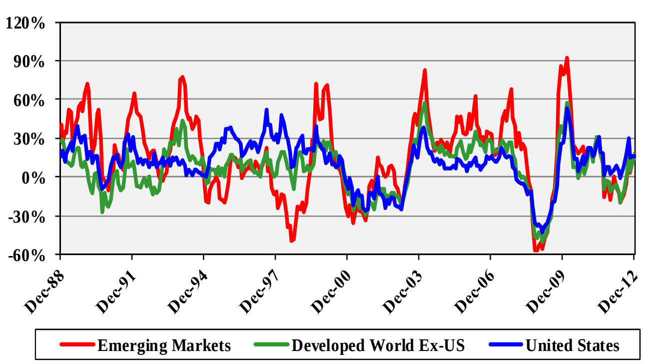


Conclusion

An investor's long-term exposure to equities may be the most important factor in determining their overall risk and return. Historically, portfolios with higher equity weights have delivered higher returns over long time-periods, but have done so with considerably more risk. Consequently, investors who cannot tolerate large fluctuations in the value of their portfolio should limit their overall exposure to equities. However, investors with long time-horizons and a relatively high tolerance for risk should consider more aggressive portfolios with a higher allocation to equities in order to maximize their long-term returns.

We also believe that balanced portfolios benefit from the inclusion of foreign equities. Emerging market equities offer the potential for higher long-term returns, and both emerging and foreign developed market equities provide significant diversification benefits. As a result, we recommend balanced portfolios with an appropriate level of globally diversified equity exposure to provide the best risk adjusted returns to long-term investors.

Figure 5 - Trailing 12-Month Equity Market Returns



Sources: Russell, MSCI (as of July 2013), Stairway Partners

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3 Year Annualized Return Estimates for Global Markets

11/1/2013	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**2.0%**	**4.5%**	**-2.5%**	**1.5%**	**4.1%**	**-2.6%**
Large & Mid Cap	**2.6%**	**4.4%**	**-1.8%**	**2.0%**	**4.0%**	**-2.0%**
Growth	2.1%	4.7%	-2.6%	1.6%	4.3%	-2.7%
Value	3.2%	4.2%	-1.0%	2.5%	3.8%	-1.4%
Small Cap	**-1.8%**	**5.1%**	**-6.9%**	**-1.3%**	**4.7%**	**-6.0%**
Growth	-3.2%	5.5%	-8.7%	-2.4%	5.1%	-7.5%
Value	-0.3%	4.7%	-5.0%	-0.2%	4.3%	-4.5%
Foreign Developed Markets	**10.4%**	**5.0%**	**5.5%**	**7.9%**	**4.6%**	**3.4%**
EMU	15.5%	5.3%	10.2%	11.8%	4.9%	6.9%
UK	18.9%	5.3%	13.6%	14.3%	4.9%	9.5%
Japan	0.1%	5.4%	-5.2%	0.2%	5.0%	-4.8%
Canada	-2.4%	4.7%	-7.1%	-1.8%	4.3%	-6.1%
Emerging Markets	**22.1%**	**6.2%**	**15.9%**	**16.5%**	**5.8%**	**10.7%**
Fixed Income						
US Aggregate	**-1.1%**	**2.5%**	**-3.5%**	**-1.4%**	**2.1%**	**-3.5%**
US Treasuries						
2 Year	-0.2%	1.3%	-1.5%	-0.5%	0.9%	-1.4%
5 Year	-2.2%	1.7%	-3.9%	-2.1%	1.3%	-3.5%
10 Year	-3.6%	2.2%	-5.8%	-3.3%	1.8%	-5.1%
30 Year	-4.6%	2.4%	-7.0%	-4.1%	2.0%	-6.1%
TIPS						
5 Year	-1.6%	1.8%	-3.4%	-1.7%	1.4%	-3.1%
10 Year	-3.1%	2.3%	-5.4%	-2.9%	1.9%	-4.8%
30 Year	-8.4%	2.6%	-11.1%	-6.7%	2.2%	-9.0%
Municipal	**3.0%**	**1.8%**	**1.2%**	**3.0%**	**1.4%**	**1.6%**
2 Year	0.1%	1.2%	-1.0%	0.5%	0.8%	-0.3%
5 Year	-0.6%	1.5%	-2.1%	0.1%	1.1%	-1.0%
10 Year	0.6%	1.9%	-1.4%	1.2%	1.5%	-0.3%
20 Year	6.5%	2.1%	4.4%	6.0%	1.7%	4.2%
High Yield	**-0.6%**	**3.4%**	**-3.9%**	**-1.6%**	**3.0%**	**-4.5%**
High Quality High Yield	-0.3%	2.5%	-2.8%	-1.3%	2.1%	-3.4%
Emerging Market ($ denomimnated)	**-0.4%**	**3.6%**	**-4.0%**	**-1.3%**	**3.2%**	**-4.5%**
Foreign Aggregate	**-2.6%**	**3.9%**	**-6.5%**	**-2.4%**	**3.5%**	**-5.9%**
Foreign Aggregate (hedged)	-3.0%	2.2%	-5.2%	-2.6%	1.8%	-4.4%
Foreign Treasury	**-2.3%**	**3.4%**	**-5.8%**	**-2.1%**	**3.0%**	**-5.1%**
Foreign Treasury (hedged)	-3.3%	1.8%	-5.1%	-2.7%	1.4%	-4.0%
Cash	**0.9%**	**0.9%**	**0.0%**	**0.5%**	**0.5%**	**0.0%**
Foreign Currency (versus US$)						
Euro	-2.4%	2.3%	-4.7%			
British Pound	-0.9%	2.2%	-3.1%			
Japanese Yen	4.6%	2.4%	2.1%			
Canadian Dollar	-0.1%	1.4%	-1.5%			

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:
   - 43.4% Ordinary Income, 23.8% Qualified Income, 0% Exempt Income, and 23.8% Capital Gains/(Losses)