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Monthly

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US Equity Valuation & Strategy

Introduction

Coinciding with equity markets making multi-year highs, investor sentiment has improved markedly. This is in sharp contrast to the weak market conditions that existed in May and June which caused many market participants to become bearish. This trend-following behavior often leads to poor asset allocation decisions. In this *Monthly,* we will review our process for evaluating the equity market.

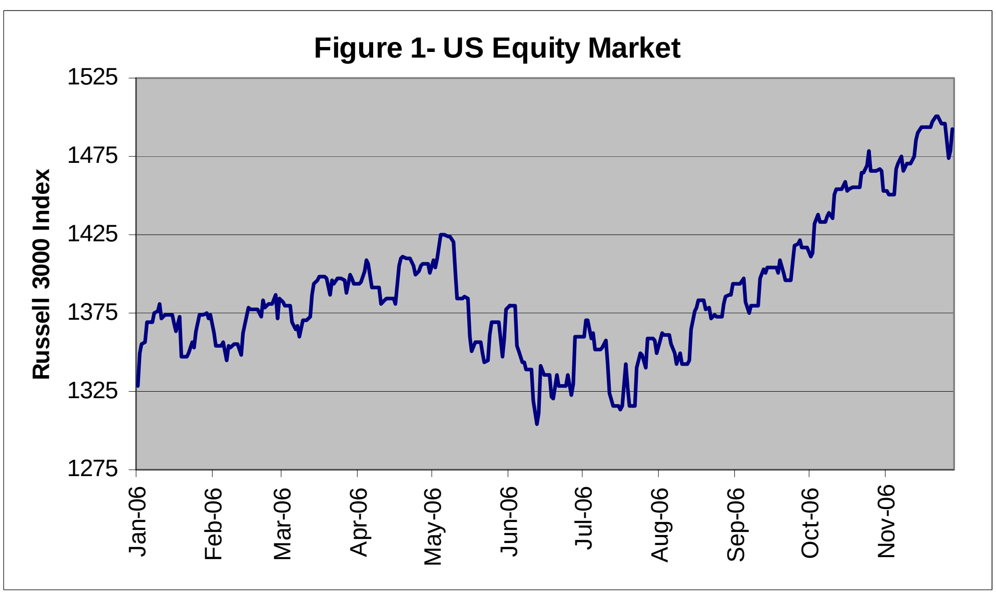
Background

Investors, who often extrapolate the recent past, typically buy when news and returns have been good, then sell when they have been bad. Many come to realize only with hindsight that they have received poor investment results.

It makes sense to us that it's better to buy an asset at lower prices rather than at higher prices. Investors should have the courage to buy when others are pessimistic and prices are low, as this provides room for upside surprises in fundamentals and market sentiment. Conversely, investors should have the discipline to evaluate a rapidly appreciating market to determine when prices are ahead of the fundamentals and risks become skewed to the downside.

The current market environment is an interesting study in fundamentals and sentiment. The equity market turmoil in May and June panicked many investors. Now, after the strong run-up since July (Figure 1), it seems that investors believe equities have attractive prospective returns. The rationale is that earnings, which have grown at a double digit rate for five years, will maintain this strong pace, supporting similar strong returns in the future. Is it likely for this growth

(Continued on page 2)



Source: Russell

Current topics

US Equity Valuation and Strategy

- *Introduction*
- *Background*
- *The Earnings Cycle*
- *Our Framework*
- *Strategy*
- *Conclusion*

Strategy

We have moved to a small underweight in US equities. This accompanies our underweight in non-US equities, high yield, and emerging debt.

"After the strong run-up since July, it seems that investors believe equities have attractive prospective returns"

US EQUITY VALUATION & STRATEGY - CONT'D

rate to continue and investors' optimistic return expectations to be realized?

The Earnings Cycle

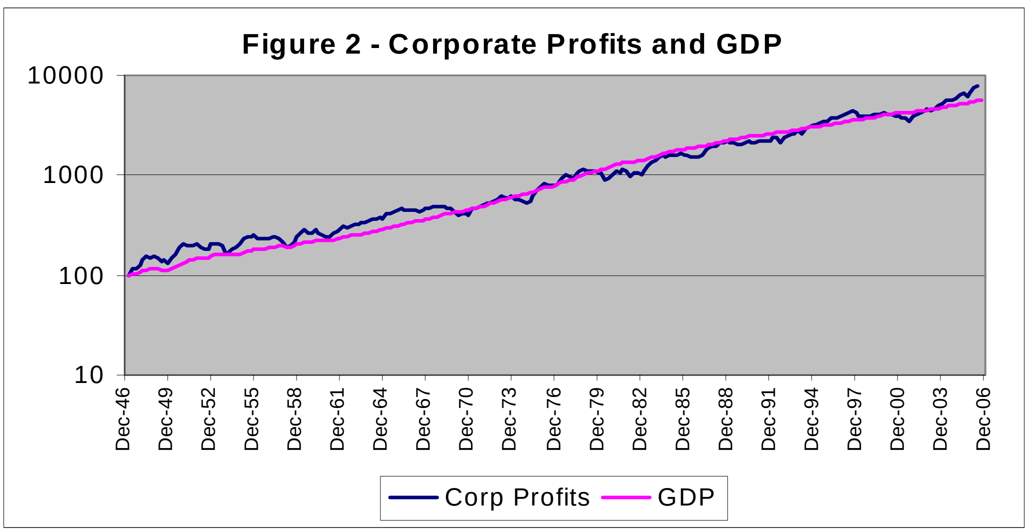
As we have written about in the past, earnings growth over time should mirror nominal economic growth. Figure 2 shows the level for both GDP and corporate profits since 1947. There are periods when earnings move above or below the trend of the economy but any divergence can not last indefinitely.

The high level of earnings growth has come in part from rapid productivity growth and a strong economy. In addition, profit margins have widened to a very high level. As a result, corporate profits as a percentage of GDP are near their historical peak. Even Fed Chairman Bernanke commented recently on the elevated level of profits. He mentioned however that higher labor costs might cause profit margins to narrow if companies can't pass on the higher costs. At some point, we anticipate that the earnings growth rate will moderate, reflecting the broader economic environment.

A good illustration of the cyclicality in earnings and how it affects investors occurred earlier this decade. In the aftermath of the excesses of the '90s, earnings dropped significantly. As Figure 3 shows, the equity market price-to-earnings ratio moved to a very high level right before the market bottomed. This was primarily a result of the precipitous and temporary decline in earnings. In hindsight, investors who took this high P/E as a sign of overpricing sold at a very inopportune time. Earnings were about to rebound sharply, producing five consecutive years of double digit gains and strong market returns. This is the reason we do not use the price-to-earnings ratio as a measure of value.

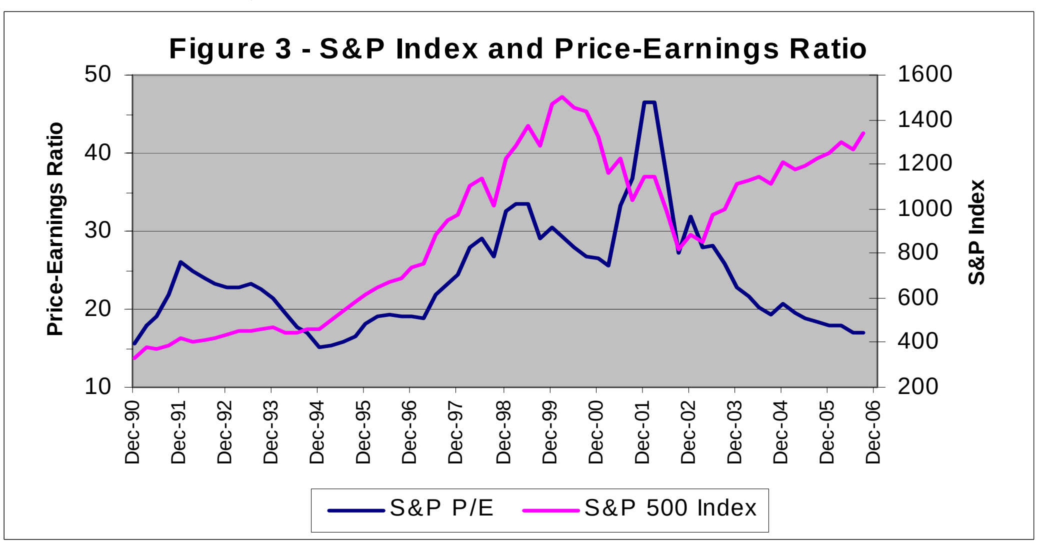
Our Framework

In order to assess fundamental value, we need to have a good sense of where earnings are today, where they are likely to go, and what other investors have embedded in prices. If earnings are well above or below the level that is consistent with long-term economic fundamentals, we believe that they will over time move back to a more normal trend. We want to overweight equities when investors extrapolate near-term bad news and drive prices below our assessment of fair value. Conversely, we want to identify periods when investor expectations for earnings growth are too high, causing prospective returns to be insufficient for



Sources: BEA, Stairway Partners

Note: Level indexed to 100 Q1 1947



Source: Standard & Poors

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.

the risk.

Our goal is to look beyond the current environment to assess where the risks and opportunities are in the long-term. To gauge this, we incorporate in our estimates earnings that are consistent with economic growth. This provides us with a fundamental input that ignores the often misleading shorter-term cyclicality of earnings.

We fully acknowledge that our methodology is not meant for short-term trading decisions. Rather it is an objective tool to better understand the balance between risk and opportunity in the long-run. Figure 4 shows that the growth rate of earnings has been running significantly faster than the growth rate in the economy. As mentioned earlier, this difference in growth rates can not be sustained indefinitely. We believe that it is the earnings growth that will have to moderate rather than GDP growth accelerating.

Strategy

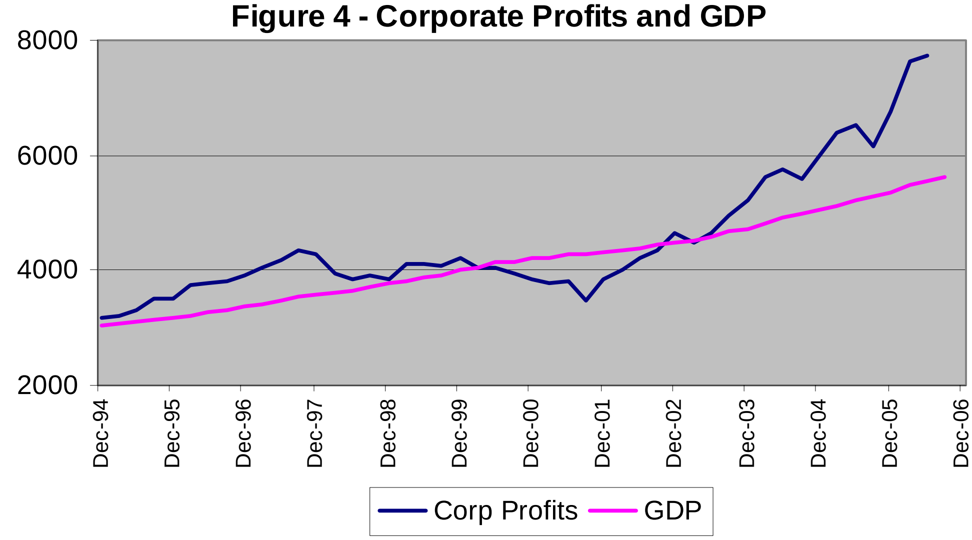
Given that earnings growth is above trend, and applying a reasonable discount rate to future earnings, we conclude that equities are somewhat overvalued. We fully recognize that periods of undervaluation or overvaluation in markets can persist. A good example of how far equity markets can move away from fair value occurred during the late nineties, although that episode was clearly more extreme.

Given the recent pricing in the US equity market, we moved to a small underweight. As part of our discipline, we implement strategy changes in a graduated approach consistent with movements in the market. A maximum under or overweight should only occur in extreme market environments. This initial underweight in US equities accompanies our small underweight in non-US equity markets, high yield and emerging debt.

Conclusion

Markets in the near-term are difficult to predict. Long-term views on earnings and risk are critical inputs to objectively assess value. Earnings growth has been much stronger than underlying economic growth, a trend that is unsustainable. Given current equity pricing, we conclude that the adjustment to a more normal level of earnings growth makes the equity market somewhat overvalued. As a result, we maintain equity market exposure below benchmarks across portfolios.

Figure 4 - Corporate Profits and GDP



Sources: Bureau of Economic Analysis, Stairway Partners

"This difference in growth rates can't be sustained indefinitely"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	3.5%	8.5%	small under	Given recent gains, we have reduced exposure from neutral
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	0.1%	7.4%		
Japan	-8.4%	4.5%		
UK	5.0%	8.5%		
Emerging	-1.3%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.6%	4.6%		
5-Year	4.3%	4.7%		
10-Year	3.6%	4.9%		
30-Year	2.5%	5.0%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.5%	3.3%		
5-Year	3.5%	3.5%		
10-Year	3.6%	3.7%		
30-Year	5.5%	4.1%		
US High Yield	4.2%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.2%	4.3%		
Japan 10-Year	0.5%	2.0%		
UK 10-Year	3.5%	5.0%		
Emerging Markets Debt	3.5%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-4.3%	-4.2%	-2.2%	Recent appreciation has made Euro more expensive
Japanese yen	4.6%	-3.9%	5.0%	Yen is slightly attractive
UK pound	-6.1%	-1.1%	-2.7%	Pound remains somewhat expensive

Notes: **As of: 11/30/2006**

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.