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Monthly

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Earnings and Equity Valuation

Introduction

Nearly all of the companies in the S&P 500 Index have reported earnings for the third quarter, and the results are weak compared to expectations and prior quarters. In fact, this is the first time since the fourth quarter of 2002 that earnings growth relative to the same quarter the year before was negative. According to Standard & Poor's, fourth quarter earnings expectations for companies in the S&P 500 have been revised downward, but this weakness is expected to be short-lived. Some investors insist that, despite the recent earnings slowdown, the equity market looks attractive because of a reasonable price-to-earnings ratio (P/E). In this *Monthly*, we will examine the current earnings cycle, how the P/E ratio is used as an indication of equity market attractiveness, and how that differs from the valuation methodology that we use.

Earnings Cycle

Since early 2004, the earnings per share (EPS) of the S&P Index has been above its long-term trend line (Figure 1). The figure also shows that periods when EPS crosses below its trend line coincided with recessions, with the only exception being the lead up to the October 1987 market crash.

Investor expectations for earnings growth next year, according to Standard & Poor's, accelerate to more than 20% in the second half of 2008. Our belief is that earnings growth will be below this consensus and that investors will continue to revise their earnings growth expectations downward in the near future.

P/E Approach

Earnings are an integral part of many valuation methodologies, one of which is

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Current topic

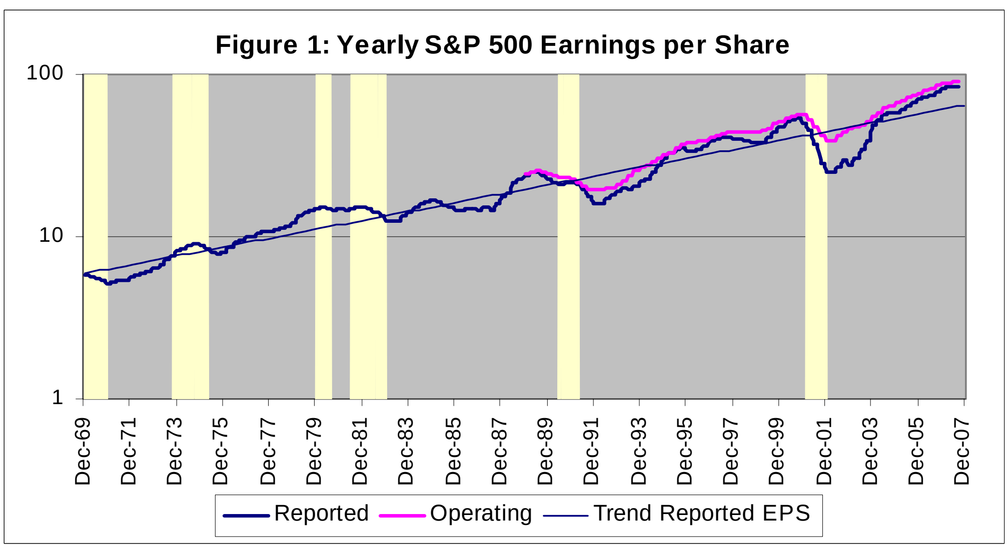
Earnings Update

- *Introduction*
- *Earnings Cycle*
- *P/E Approach*
- *Cash-Flow Methodology*
- *Conclusion*

Strategy

- *In November no changes were made to strategy*
- *High yield is becoming attractive*
- *Portfolio strategy remains underweight equities, high yield and emerging debt across portfolios*

"Since December 2003, the earnings per share of the S&P Index has been above its long-term trend line"



Source: Standard & Poor's, Haver, NBER

Note: Yellow areas are recessions

Earnings and Equity Valuation - Cont'd

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based on the P/E ratio. The P/E ratio is often used to evaluate the attractiveness or unattractiveness of individual stocks as well as the equity market as a whole. Investors using this approach typically draw conclusions based on a stock's P/E ratio relative to its past levels, its industry, or even the market in general. Currently, many investors believe that the US equity market looks attractive because of a reasonable P/E ratio relative to the past 30 years (Figure 2).

The P/E ratio is computed by dividing the current price of the stock by the annual earnings per share generated by the company. For example, a stock with a price of $85, that generates $5 of annual earnings, would have a P/E of 17 (85 divided by 5). An investor is thus paying $17 for every $1 of earnings generated by the company. In this type of analysis, some use forward-looking earnings estimates while others use the most recent trailing earnings. Computing a P/E for a broad market follows a similar approach.

As a rule of thumb, the higher the P/E ratio, the greater the expected earnings growth in the future and the more willing investors are to pay a premium for this anticipated growth. The lower the P/E, the less growth is expected and the lower the premium investors are willing to pay for the asset. As with any rule, the confusion and difficulty lie with its application.

In actual practice, no hard-and-fast rule should be drawn from the ratio itself. Using the P/E ratio to interpret value is conditional on future developments in the earnings cycle. A high P/E might signal greater future earnings growth, but it could also be the result of the stock price not yet having caught up with an earnings slowdown. In Figure 3, we expand upon the earlier example of a stock with a price of $85, earnings per share of 5, and a P/E ratio of 17. If earnings drop by 10% but the stock price only drops by 3%, the P/E ratio goes up.

So what might the increase in the P/E signal? The earnings decline could be temporary, and expectations would be for strong future earnings growth. In this case, a higher P/E and decline in stock price would signal a buying opportunity. Or the decline in earnings could be more prolonged, and expectations about the future too optimistic. This would suggest the need for the stock price to drop further, and the high P/E would be signaling an overpricing. Such confusion happened in 1999 and again in 2001 when high P/E ratios resulted in two different market outcomes.

In 1999, the P/E of the S&P 500 reached a new high above 30, just before the market experienced a significant sell-off beginning in 2000 (Figure 4). In this instance, the high P/E signaled an overpriced market and a

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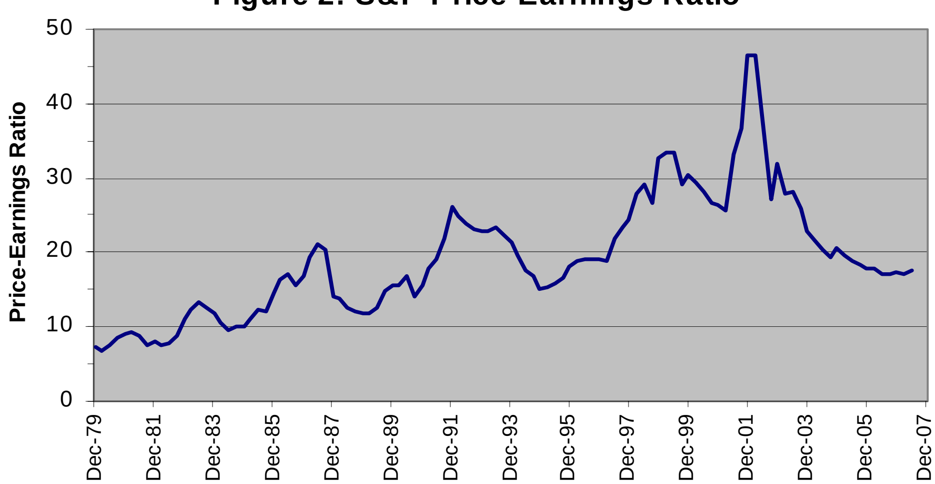
Figure 2: S&P Price-Earnings Ratio



Sources: Standard & Poor's, Haver, Stairway Partners   Note: P/E uses trailing four quarters

Figure 3: P/E Example

	Stock Price	Earnings Per Share	P/E
Initial Values	85.00	5.00	17.0
Change	-3%	-10%	
New Values	82.45	4.50	18.3

"If earnings drop by 10% but the stock price only drops by 3%, the P/E ratio goes up"

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.

time to reduce holdings. In contrast, at the end of 2001, with the equity market significantly lower, the P/E reached a peak of 47. This was actually a good time for longer-term investors to be buying, not selling, the equity market. This dramatically high P/E resulted from the disproportionate decline in earnings relative to stock prices. Any investor who viewed this high P/E ratio as a sign of overpricing sold at a inopportune time. Earnings subsequently rebounded sharply, resulting in 6 years of strong equity market returns.

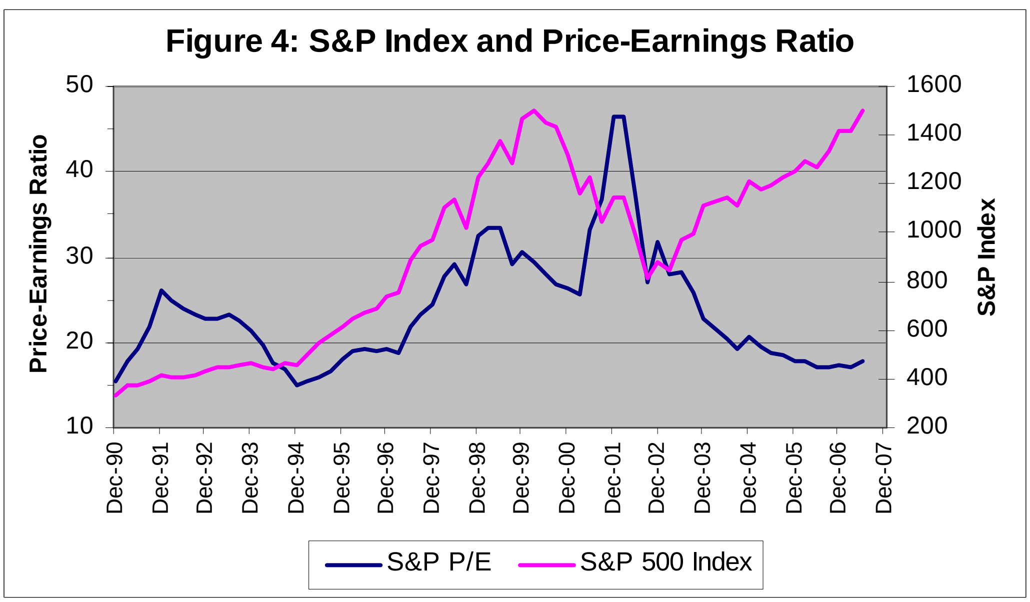
Cash-Flow Methodology

Our preferred methodology is to value equities based on their long-term earnings prospects. This involves looking through the earnings cycle and not reacting to or extrapolating recent trends. How we determine the fair value of the equity market is analogous to how an investor might value a business. We evaluate cash flows that accrue to the investor in the future and discount them back to the present using an appropriate discount rate. In our process, the discount rate is commensurate with the level of risk for the asset class; the higher the risk, the greater the discount rate. We can then compare this present value with the current market price to make an assessment as to the asset's attractiveness—whether it is overpriced or underpriced.

Conclusion

For several years, earnings in the US stock market have been above their long-term trend. In the third quarter, earnings are likely to have declined for the first time in nearly five years. While expectations for fourth quarter earnings have been revised downward, forecasts gathered by Standard & Poor's show earnings rebounding in 2008, with reasonably strong growth throughout the year.

The market P/E today has moved slightly above its average since the start of the 1980s, primarily due to the recent drop in earnings. As discussed, P/E as a valuation metric can send mixed messages. As an alternative, the cash flow methodology is better suited to look through the cyclicality of earnings in evaluating equity markets. Using this approach to determine fair value, even with the recent downturn, the US equity market today is still modestly overpriced.



"AT THE END OF 2001, WITH THE EQUITY MARKET SIGNIFICANTLY LOWER, THE P/E REACHED A PEAK OF 47. THIS WAS ACTUALLY A GOOD TIME FOR LONGER-TERM INVESTORS TO BE BUYING, NOT SELLING, THE EQUITY MARKET"

Sources: Standard & Poor's, Stairway Partners

Note: P/E uses trailing four quarters

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	4.2%	8.4%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	2.4%	8.1%		
Japan	-4.8%	4.8%		
UK	7.0%	9.0%		
Emerging	-8.4%	11.4%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector has become expensive, particularly at longest maturities
2-Year	2.9%	3.8%		
5-Year	2.6%	4.2%		
10-Year	2.4%	4.6%		
30-Year	1.8%	4.9%		
US Municipal Bonds			neutral	Yields at most maturities fairly priced
2-Year	3.3%	3.3%		
5-Year	3.4%	3.5%		
10-Year	3.7%	3.8%		
30-Year	6.2%	4.2%		
US High Yield	6.9%	6.9%	under	Sector has become more attractive as spreads have widened
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	3.2%	4.6%		
Japan 10-Year	0.1%	2.0%		
UK 10-Year	3.6%	5.1%		
Emerging Markets Debt	2.8%	7.1%	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	-7.9%	-5.5%	-4.6%	Euro is expensive
Japanese yen	3.4%	-1.3%	3.5%	Yen is slightly attractive
UK pound	-7.3%	-0.3%	-3.7%	Pound is expensive

Notes: **As of: 11/30/2007**

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.