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MONTHLY

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VALUE IN EUROPEAN EQUITIES

Introduction

The European debt crisis has buffeted global markets since the latter half of 2009. In the June 2010 *Monthly* - "European Equity Update", we reviewed our critical assumptions around currency and equity market valuations and discussed how then-current events might influence returns going forward.

Over the two and a half years that have passed since then, daily headlines on the European crisis have persisted, as a lasting resolution continues to elude policy makers. Despite the negativity caused by these near-term events, we believe that European equities are likely to provide very good returns over the next several years.

In this *Monthly*, we provide an update on the state of the fundamental factors that drive our valuations for European equities and the European common currency. We also discuss how these factors and market returns have evolved since our last update.

Earnings Update

Corporate earnings are at the heart of our valuation process for all equity markets. Over time, we believe that long-term trends in economic activity drive long-term trends in earnings, which in-turn drive equity market returns. Unfortunately, over shorter time periods economic growth and earnings can diverge materially from their long-term trends, often resulting in extreme market movements. This is because investors often extrapolate current weakness long into the future during recessions, or increase their long-term earnings forecasts during times of extraordinary growth.

Figure 1 shows the reported earnings for the MSCI EMU index, which includes companies domiciled within the major developed countries that use the Euro as their currency. The figure shows that the debt crisis in Europe has indeed affected corporate earnings,

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CURRENT TOPIC

Value in European Equities

- *Introduction*
- *Earnings Update*
- *Equity Market Valuation*
- *Euro Valuation*
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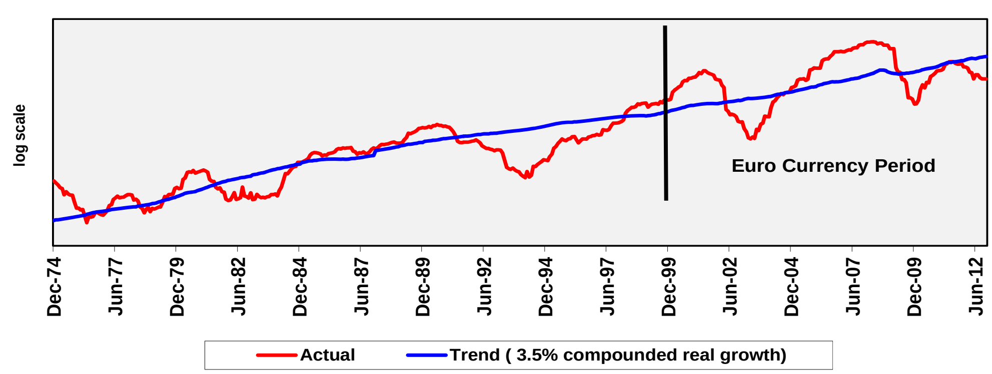
Strategy

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

"ALTHOUGH THE RECENT DROP IS NOTEWORTHY, IT PALES IN COMPARISON TO THE 58% DROP THAT OCCURRED DURING THE GLOBAL FINANCIAL CRISIS IN 2008 AND 20009"

Figure 1 - MSCI EMU Earnings

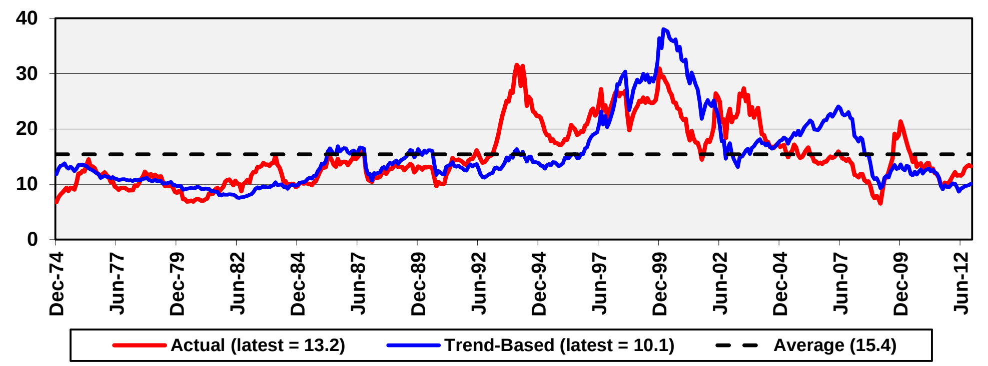


Sources: MSCI, Bureau of Labor Statistics, Stairway Partners

VALUE IN EUROPEAN EQUITIES - CONT'D

"AT 10.1 OUR TREND-BASED P/E RATIO IS NEAR THE LOWEST LEVEL IN ITS THIRY EIGHT YEAR HISTORY, WHICH WOULD INDICATE THAT FUTURE RETURNS COULD BE SIGNIFICANT"

Figure 2 - European Equity P/E Ratios



which have declined roughly 15% from their recent peak in the middle of 2011. Although the recent drop is noteworthy, it pales in comparison to the 58% drop that occurred during the global financial crisis in 2008 and 2009.

Figure 1 also illustrates that over time there is a relatively stable trend of real growth that we believe better describes the long-term earning capability of European companies. We use this trend as the starting point to estimate future earnings.

The severity of the events in Europe has caused some investors to question the viability of the European currency union, and forecast a return to national currencies for the member countries. This negative view of the Euro is often extrapolated into a dire outlook for European companies. We do not believe that the Euro materially altered the long-term earning capability of European companies when it was created, and therefore do not believe that its dissolution would have a lasting impact. This is based on our confidence in the long-term durability of the European economy and the ability for European companies to generate profits outside of their domestic markets. Our view is reinforced by the stability of the earnings trend shown in Figure 1, before and after the adoption of the Euro.

Equity Market Valuation

We believe that investors' current pessimism toward European sovereign governments has depressed equity prices, making market valuations more attractive on a forward looking basis. Our current valuation estimates which appear on page 4 show that we expect European equities to produce significant returns over the next three years. These expected returns are based on a proprietary discounted cash -flow model, which is our primary valuation metric.

A more broadly used valuation metric which may be may be more familiar to our readers is the Price/ Earnings (P/E) ratio. Although P/E ratios are not part of our formal valuation framework, we believe that they provide additional insight into market pricing. Figure 2 shows the P/E ratio for European equities calculated using both actual earnings and our trend-based earnings estimates. Because our trend tracks actual earnings over time, they both have roughly the same average of 15.4.

Research that we did for the October 2010 *Monthly* – "Valuation Drives Equity Returns" showed that P/E ratios based on trend earnings provided the best insight into future equity market returns. Historically, lower readings for this measure preceded higher equity market returns. At 10.1 our trend-based P/E ratio is near the lowest level in its thirty eight year history, which would indicate that future returns could be significant.

It is also worth noting that while European equities have lagged other developed markets in recent years, that their performance has been much better than the headlines would imply. In the two and a half year period since we last wrote on this topic, The MSCI EMU index produced a positive return of 16.2% (6.2% annualized) for US Dollar based investors.

Euro Valuation

Unless investors in foreign markets hedge, they are subjected to currency risk as income and principal gains generated offshore are repatriated. As a result, we believe that it is important for US investors to recognize the impact that changes in the

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Source: MSCI, Bureau of Labor Statistics, 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)

Euro's exchange rate versus the dollar will have on their European equity returns.

It is extremely difficult to determine the near-term directions of currency markets. However, we believe that there are fundamental factors which can help to predict the direction of foreign exchange rates over longer time-periods. To value currencies we employ a Purchasing Power Parity (PPP) model, which is based on the theory that relative inflation will ultimately determine the direction of exchange rates, over time. The concept behind all PPP models is relatively simple. A country with higher inflation should expect its currency to depreciate relative to a country with lower inflation. We have written extensively about our currency forecasting methodology in the past, most recently in the November 2010 Monthly – "Currency Wars? Not Really".

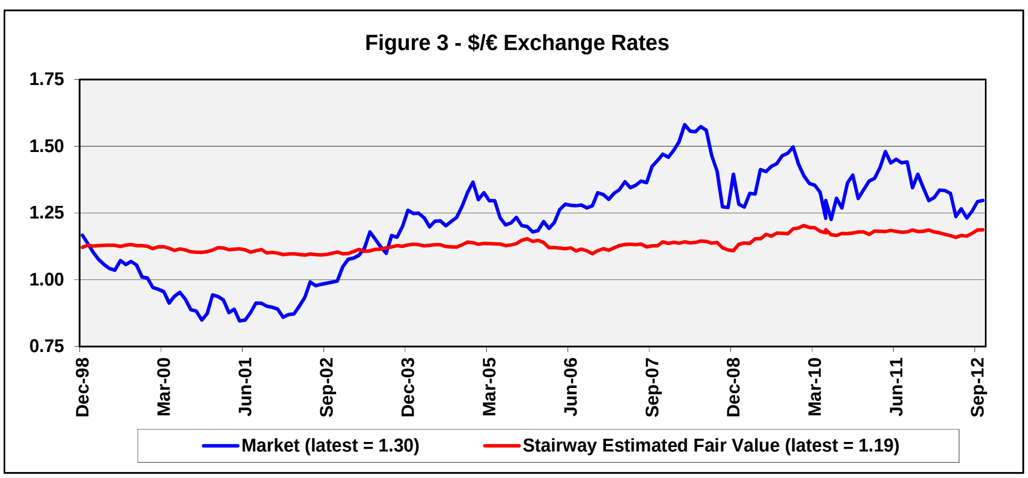
Figure 3 shows the market exchange rate for the Euro along with our fair value estimate since the currency's inception on January 1st, 1999. Over this time period our estimated fair value for the Euro has increased by roughly 6%, due to inflation being lower in Europe than it was in the United States. Looking back over this time period, the Euro experienced more appreciation and has remained above our fair value estimate since the middle of 2003.

Based on our assumptions, the Euro is currently about 9% overvalued versus the US Dollar. As a result, we would expect the currency to depreciate and reduce European equity returns by roughly 3% per annum over a three year investment horizon. ***Even after accounting for this anticipated currency loss, European equities are still expected to produce significantly positive returns.***

Conclusion

Daily headlines can distort people's perception of both past performance and the prospects for future returns. Although the problems that have been unfolding in Europe since the end of 2009 are significant, we do not believe that they materially change the long-term earnings capabilities of European companies.

Based on today's market prices and our long-term estimates of corporate earnings, we believe that European equities are poised to produce strong returns over the next three years. Although the Euro appears to be modestly overvalued, we do not believe that its future depreciation will materially detract from the much larger potential returns of the European equity market.



Sources: Bloomberg, Bureau of Labor Statistics, Stairway Partners

"BASED ON OUR ASSUMPTIONS, THE EURO IS CURRENTLY ABOUT 9% OVERVALUED VERSUS THE US DOLLAR"

3 Year Annualized Return Estimates for Global Markets

12/3/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**10.2%**	**4.0%**	**6.2%**	**8.6%**	**3.8%**	**4.8%**
Non-US Developed Markets	**18.5%**	**4.5%**	**14.0%**	**15.7%**	**4.3%**	**11.4%**
EMU	25.3%	4.9%	20.5%	21.5%	4.7%	16.8%
UK	24.6%	4.8%	19.8%	20.8%	4.6%	16.2%
Japan	11.0%	4.9%	6.1%	9.3%	4.8%	4.6%
Canada	-1.7%	4.3%	-6.0%	-1.4%	4.1%	-5.5%
Emerging Markets	**20.6%**	**5.7%**	**14.8%**	**17.2%**	**5.6%**	**11.6%**
Fixed Income						
US Aggregate	**-1.8%**	**2.0%**	**-3.9%**	**-2.1%**	**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%	-2.5%	1.1%	-3.7%
10 Year	-5.9%	1.8%	-7.7%	-5.4%	1.7%	-7.1%
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	-6.6%	1.9%	-8.5%	-6.0%	1.8%	-7.7%
30 Year	-15.3%	2.3%	-17.6%	-13.0%	2.1%	-15.1%
Municipal	**-1.3%**	**1.4%**	**-2.7%**	**-0.6%**	**1.2%**	**-1.9%**
2 Year	0.1%	0.7%	-0.6%	0.3%	0.5%	-0.3%
5 Year	-1.5%	1.1%	-2.5%	-1.0%	0.9%	-1.9%
10 Year	-2.7%	1.5%	-4.2%	-1.8%	1.3%	-3.2%
20 Year	-1.1%	1.8%	-2.9%	-0.4%	1.6%	-2.0%
High Yield	**1.8%**	**2.9%**	**-1.1%**	**0.3%**	**2.8%**	**-2.5%**
High Quality High Yield	1.7%	2.1%	-0.5%	0.3%	2.0%	-1.7%
Emerging Market ($ demonimnated)	**-2.0%**	**3.2%**	**-5.2%**	**-2.6%**	**3.0%**	**-5.7%**
Foreign Aggregate	**-3.9%**	**3.4%**	**-7.3%**	**-3.6%**	**3.3%**	**-6.9%**
Foreign Aggregate (hedged)	-3.5%	1.7%	-5.2%	-3.4%	1.6%	-4.9%
Foreign Treasury	**-3.7%**	**3.0%**	**-6.7%**	**-3.5%**	**2.8%**	**-6.3%**
Foreign Treasury (hedged)	-3.7%	1.3%	-5.0%	-3.5%	1.1%	-4.6%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Foreign Currency (versus US$)						
Euro	-2.4%	2.3%	-4.7%			
British Pound	-0.5%	2.2%	-2.7%			
Japanese Yen	2.0%	2.4%	-0.4%			
Canadian Dollar	-0.7%	1.4%	-2.2%			

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)