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Point of Action: Reducing U.S. Exposure, Adding to Foreign Markets

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2011 Outlook

GDP Growth	1.8%
Unemployment	9.0%
Inflation	1.75%
Fed Funds Rate	0.25%

Background – Why We Have Had a Pro-U.S.Skew

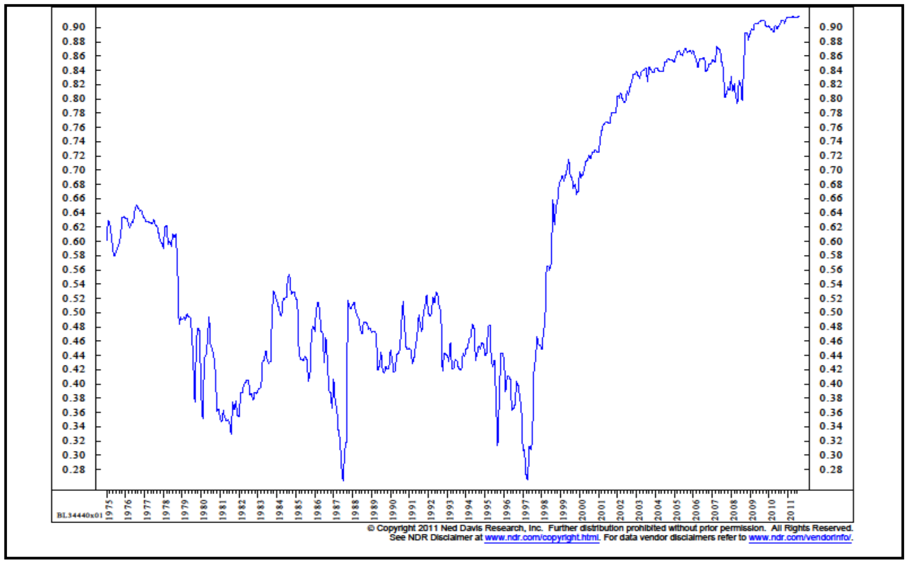
Within our Global Equity portfolios, we have been overweight U.S. equity exposure at the expense of our foreign exposure, relative to the MSCI World Index. Our reasons for this overweight exposure to U.S. equities compared to other markets are currently evident. We highlighted our thoughts in our piece dated Aug. 16 "L 'Evenement Principal". At the time, we suggested:

"At the end of the day, we believe the systemic risks radiating from Europe are the real drivers behind the financial system's increased level of volatility we have witnessed during the last few weeks. That is where the real "show" is currently being played out, not in Washington or Tokyo. We in the U.S. are still dealing with our own "Main Event". A new show has opened in Europe. European politicians and central bankers are running out of time to address the authority and responsibility imbalance currently in place."

With this in mind, we have been actively engaged throughout this year in increasing the pro-U.S. skew. At the beginning of 2011, we were overweight U.S. exposure by 3% as compared to the MCI World Index. Currently our overweight stands at 11%, representing a significant macro skewing. So far this year, these moves have been productive in a relative-return sense, as the U.S. has outperformed many other major markets and the index as a whole.

We have come to the decision to alter this overweight, as the weight of the evidence suggests the probability, perhaps over a short period of time, that some foreign markets may be poised to perform more "in-line" with global indexes than has been the case for some time.

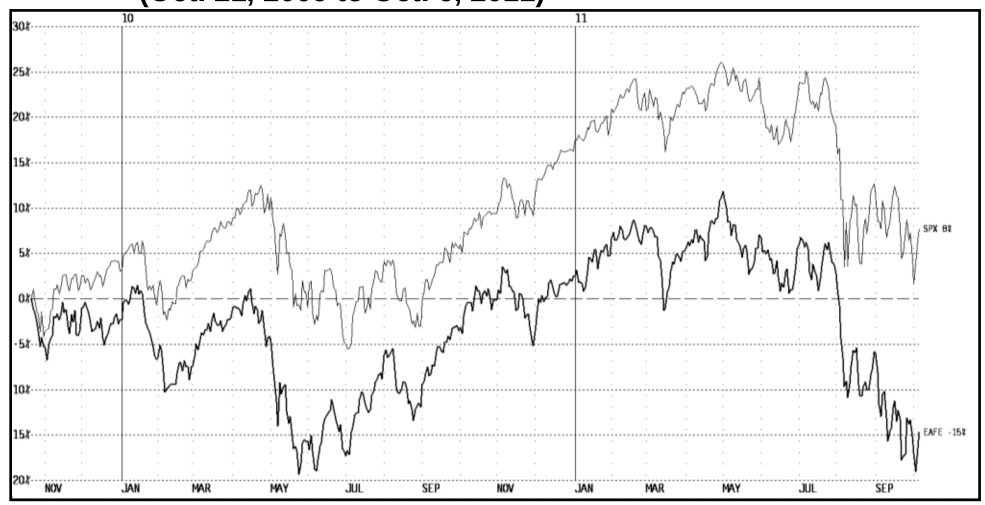
Chart 1 – Rolling 60-Month Correlation of the One-month Changes Between the S&P 500 and the MSCI EAFE Index



Source: Ned Davis Research Inc.

Between the mid-1990s and fall 2009, U.S. and international equity markets became more closely correlated. In the past two years, however, a performance disparity has grown.

Chart 2 – Relative Returns S&P 500 and the MSCI EAFE Index (Oct. 21, 2009 to Oct. 6, 2011)



Source: Baseline

Kissing Cousins

When thinking about various market-to-market movements, a number of issues need to be viewed. We start with historical correlations of returns between various markets since 1975. Chart 1 shows that the correlation coefficient (how tightly correlated one asset class returns have been relative to another) between the S&P 500 and the EAFE indexes have become very tight. From 1978 to 1998, the return spread between the S&P 500 and EAFE was positive, but loose, ranging from 0.27 and 0.53. From 2000 to 2010, those correlations have not only been positive, but very tight, ranging between 0.68 and 0.92 – the S&P Index and the EAFE Index have become “kissing cousins”. This makes fundamental sense, as a significant portion of revenues and profits of the average S&P 500 company are highly dependent on foreign revenue flows. One would expect the markets to trade in a reasonably “like” fashion.

EAFE vs. S&P – The U.S. Has Been Standing Tall

Over the last two years the markets have diverged in returns to a drastic extent. (due in our opinion primarily to the issues outlined in our “L‘Evenement Principal” piece). On a price-only basis, since Oct. 21, 2009 to Oct. 6, 2011, the S&P 500 Index is up 8% (See Chart 2). Over that same period, the EAFE Index is down 15%, representing a “spread” in return of 2,300 basis points, or 23%. Some have asked if this difference in performance has to do with currency; the dollar is up 3% relative to a broad- based basket of foreign currencies over this same period. Consequently, the vast majority of this return spread is not due to currency. Rather, it is due to underperformance of foreign equity markets relative to the U.S.

This is a highly unusual outcome of two asset classes which have become, over the last 10 years, very highly correlated. On a relative return basis, the U.S. is standing tall, while much of the rest of the world has been getting crushed.

Enter Valuation

We are of the opinion that valuation is a lousy “timing” tool. It is primarily to be used to discern if valuation “spreads” start to close, how much outperformance/underperformance should one expect. Observing current valuation and saying something is “undervalued” is a judgment statement and is highly subjective. On the next page is an attempt to provide some guidance as to “relative valuation” given what we know rather than what we expect. We need to understand what valuation is being afforded
With this in mind, we are lowering our overweight position

current markets relative to each other and relative to “normalized” valuation patterns.

Four valuation measures we use and compare to five-year averages are:
- Earnings yield
- Dividend yield
- Book value yield (book value to price) and
- Cash flow yield (cash flow to price).

The following table highlights **valuation discounts relative to the past five-year averages.** At current valuation levels, major regional markets rank as follows:

	EY	DY	BVY	CFY	AD
World	-28.3%	-15.8%	-27.3%	-21.1%	-23.1%
U.S.	-35.5	-12.4	-22.1	-20.9	-22.7
Europe (ex. U.K.)	-29.5	-29.9	-36.2	-25.0	-30.1
U.K.	-14.2	-2.7	-28.3	-18.6	-16.0
Pacific (ex. Japan)	-36.0	-14.2	-30.4	-31.7	-28.1
Japan	-32.7	-36.8	-35.7	-26.6	-33.0

EY = earnings yield; DY = dividend yield; BVY = book value yield; CFY = cash flow yield; AD = average discount

Per the above analysis, on a relative basis (intra and inter-markets) Japan appears to be statistically the most undervalued major market, followed by mainland Europe. Next comes the rest of the Pacific region followed by the U.S. and finally the U.K.. London and New York (from a valuation perspective) offer less opportunity than Tokyo, Berlin and Paris, specifically on a “relative” basis.

With this in mind, we are lowering our overweight within our Global Equity portfolios. That money will now flow directly towards our large-cap international “sleeve”. It is important to understand that we are maintaining our overweight position in the U.S. relative to our index. However, we are actively reducing that skew, as we believe an unsustainable momentum and valuation dynamic has developed.

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Scout Investments

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