

FIRST QUARTER REVIEW

Relative strength began to reassert itself during the first quarter of 2010. Our strategies, which are designed to capitalize on strong relative strength asset classes and stocks, all performed well during the first three months of the year. We were certainly happy with our overall performance, and we believe high relative strength securities can continue to deliver strong returns going forward.

The biggest media story during Q1 was the passing of the Healthcare Bill. Public opinion is against this piece of legislation, but the market had other ideas! This is a perfect example of why we choose to follow trends in a disciplined manner and not let our emotions and biases cloud our judgment. The day after the bill was passed the stock market defied all odds and was up sharply. Over time, a bill of this magnitude will have an effect on the overall economy, and there will be clear winners and losers. Nobody can tell for sure (not even your Congressman!) how this will affect everything going forward. But as the changes get implemented certain companies will benefit, and this will be reflected in their share prices. Our relative strength discipline will be able to find the leaders regardless of what sector they are from.

The biggest story affecting our accounts during the first part of the year was the recovery in the U.S. Dollar. Surprisingly to us, this hasn't received as much media attention as we would have thought. The Dollar has been declining for quite some time. A declining U.S. Dollar has a great impact on asset allocations. When the Dollar is weak, assets denominated in foreign currencies tend to perform much better than assets de-

nominated in our home currency. Foreign stocks are an example of this. A weak Dollar also benefits hard assets like commodities. The chart in the middle of the page shows the performance of the U.S. Dollar Index over the last 12 months. You can see that since the end of December, the Dollar has rallied sharply. There are a number of factors causing the rally, but we are always more interested in how the changes affect prices in capital markets. It certainly caused a trend change, and domestic securities performed much better than their weak dollar counterparts during the first quarter.

This dollar trend affected our global accounts more than our other accounts. We came into the year with a large allocation to international equities and weak dollar investments. We made dramatic changes to our allocations during the first quarter to get the accounts repositioned to the new leadership. Heading into the

second quarter, our global accounts are now much more heavily weighted in domestic equities. Making such a large transition required more turnover than usual, and we would expect trading activity to subside if these trends continue. We were also encouraged that the large changes we made led to better performance during the latter half of the quarter as the trends continued. We finished up the quarter with performance in the middle of the pack versus the various asset classes we invest in, which is where we want to be on a short-term basis. That kind of performance profile is what allows the strategy to wind up at the top of the pack over long (5 to 10 years) time horizons.



The shift to a stronger dollar environment didn't have the same effect on our domestically focused accounts. Those accounts, by definition, were already invested in dollar denominated assets and didn't have to deal with the same trend change the global accounts had to deal with. As a result, our domestic strategies did much better than their benchmarks during the first three months of the year. The bulk of the outperformance came from security selection rather than a large sector concentration. We haven't seen one sector or theme emerge and dominate like we did in the good RS markets of 2005 and 2007. We are still holding positions in a large number of sectors, and our top-down allocation model still favors a fairly equal weighting across sectors. We would expect this to change as the bull market continues. At some point, a dominant theme usually emerges and a relative strength strategy begins to overweight that theme.

The good performance by the high relative strength stocks is reflected in the RS Spread we track. We included a chart of the Spread in last quarter's letter, and we pointed out how the dramatic decline in the spread (the laggard rally) had ended and it had started to flatten out. We also noted that the flattening was very similar to the beginning of 2007—right before relative strength strategies delivered very strong performance. The updated Spread chart is shown below. The current shape of the curve is still very similar to 2007 when it took 6 months or so of "flat" performance before the Spread really began to turn up.



We are encouraged by what we are seeing in high relative strength securities, and we believe there

are some underlying factors that will allow these trends to continue. One major area we view as a positive is public sentiment toward equities. After two bear market declines in a short time period, the public is still wary of stocks. That has not been what we have seen historically at major market tops. At market tops, the public is usually euphoric about equities. But the mutual fund data shows the public has been buying bond funds, not equities. This is probably due to the perceived safety of bonds, or in the case of high-yield funds, the time-honored tradition of chasing yield. History has shown that investors chase returns time and time again so it is certainly a good possibility that much of the flow into fixed income funds will come out in search of better returns at some point in the future. If equities continue to deliver strong returns, that money may be headed for the stock market. If we begin to see that sort of flow it can be a catalyst that allows trends to run much farther than people think.

The shape of the yield curve is also very encouraging for the overall economy. The yield curve is actually one of the best economic forecasting tools around. It essentially looks at the difference in yield between long-term bonds and short-term bonds. When the yield curve is very steep (meaning long-term bonds have yields much higher than the yields of short-term bonds) it forecasts a stronger economy. The yield curve is incredibly steep right now compared to historical values. While the naysayers have all sorts of reasons why this won't lead to economic growth, the fact of the matter remains that the yield curve has been better than the economists (and the naysayers!) at forecasting the economy over time. We have also done research that shows as the yield curve begins to flatten from very steep levels, the performance of high relative strength securities is very good. This performance tends to last for quite a while—until the yield curve finally becomes inverted, which is a long way away.

We appreciate your continued trust in our systematic disciplines. While last year was difficult for relative strength, this year has gotten off to a very positive start. If you have any questions about any of our strategies please feel free to call us or your financial advisor. In addition, if you are interested in receiving more frequent updates about relative strength and how market factors are affecting our strategies you can read our updates on our blog at: www.systematicrelativestrength.com.