

*Devoted to information and portfolio strategies for the high relative strength asset class*

**Relative Strength measures...**

the price performance of a stock versus a market average or universe of stocks. A stock's relative strength can improve if it rises more than the market in an uptrend, or goes down less than the market in a downtrend.

**Feature: Thought Process**



A weather vane gives objective feedback about which direction the wind is blowing. It doesn't have a hidden agenda. It simply rotates on its axis as a result of the movement of air. Wind is the movement of air caused by uneven heating of the Earth's surface. When hot air rises and the cooler air takes its place, wind is the result.

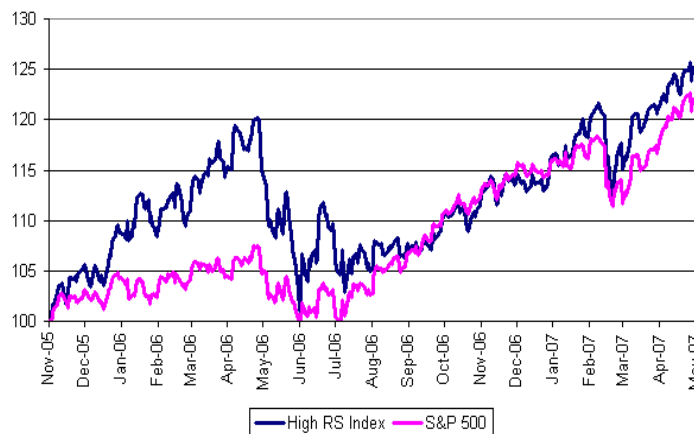
Similarly, security prices move as the result of unequal supply and demand relationship for that particular security. When there is greater demand than supply, price will rise. When there is greater supply than demand, price will fall.

Relative strength dispassionately measures that movement and points out the strongest trends.

**High RS Asset Class:**

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 5/14/07:

High RS Index vs. S&P 500 Index



"High RS Index" is a proprietary Dorsey, Wright Index composed of stocks that meet a high level of relative strength. The volatility of this index may be different than any product managed by Dorsey, Wright. The "High RS Index" does not represent the results of actual trading. Clients may have investment results different than the results portrayed in this index.

**Sector & Capitalization Snapshot**

As of 5/14/07

**Sector Performance**

S&P 500 GICS Sector	12 Month	6 Month	1 Month
Telecommunications	37.16%	17.47%	5.29%
Utilities	35.96%	17.89%	4.09%
Health Care	19.56%	10.62%	2.27%
Energy	18.77%	12.78%	4.26%
Materials	17.41%	16.64%	1.74%
Technology	16.79%	5.03%	5.05%
Consumer Discretionary	15.08%	4.02%	0.93%
Consumer Staples	14.83%	6.28%	0.33%
Financials	12.97%	4.41%	4.02%
Industrials	8.43%	8.34%	5.04%

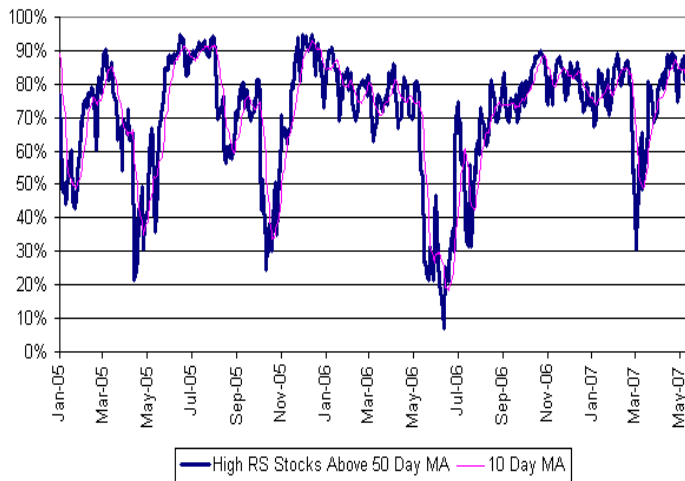
**Performance by Capitalization**

S&P Large-Cap	16.47%	7.81%	3.59%
S&P Mid-Cap	12.44%	10.55%	2.67%
S&P Small-Cap	10.58%	7.14%	1.59%

## High RS Diffusion Index

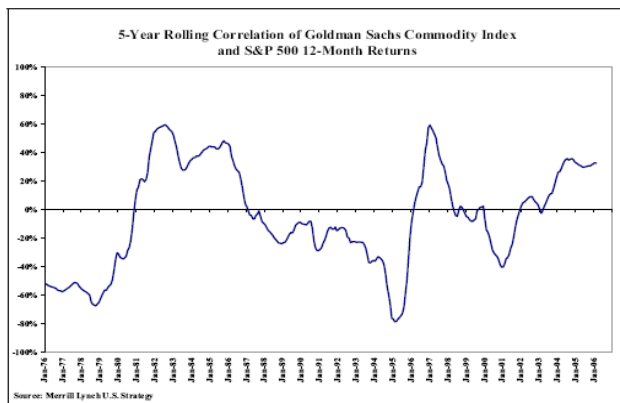
High relative strength stocks have rebounded strongly since the short correction from February and early March of this year. As of 5/14/07

Dorsey Wright High RS Diffusion Index



## Unstable Correlations

The fundamental goal of Strategic Asset Allocation (SAA) is to optimally allocate between different stocks or different asset classes. The inputs into SAA are expected return, standard deviation of each asset, and the correlation matrix between these assets. The output is the efficient frontier which provides the allocation with the highest return for the least risk. **This process would work fine if those relationships remained constant over time, but they don't.** One example is the chart below highlighting the unstable nature of correlations between commodities and the S&P 500:



Richard Bernstein, March 2006

Tactical Asset Allocation (TAA), using relative strength, takes a more proactive view on portfolio management. The goal of TAA is to systematically identify and provide exposure to leading strategy components on an ongoing basis.

## Early RS Practitioner George Chestnutt

We are aware of various relative strength practitioners going back nearly 100 years. We have studied their work and have tried to better understand the nature of relative strength investing.

One of the most successful portfolio managers who used relative strength was George Chestnutt, manager of the American Investors Fund. The fund was in existence nearly 30 years and had tremendous success. Although we don't have the track record of this fund over the entire existence of the fund, we do have various indications of its success. *Financial World* magazine reported that from the fund's inception on January 16, 1958 to March 31, 1964, the Fund had a cumulative return of 160.50%, while the Dow Jones Industrial Average returned 82.67%. We also know that *Institutional Investor* magazine called Chestnutt "one of the few surviving performance stars of the mid-1960s in an article published in 1967. Also, Lipper ranked Chestnutt's fund among the top 10 performing funds of 1979. Additionally, the fact that the American Investor's fund existed for nearly 30 years speaks to its success.

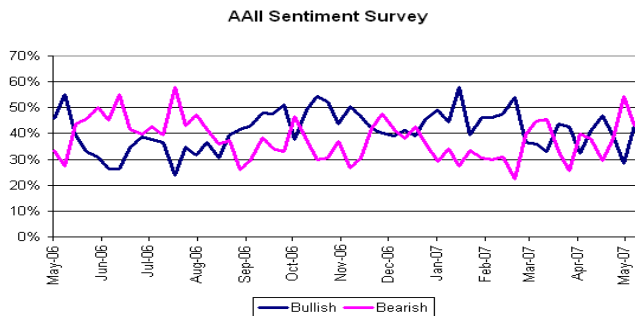
In a 1963 article in *Financial World* magazine, Chestnutt described his strategy as focusing on stocks that have exhibited a strengthening price trend. With the help of his IBM computer, Mr. Chestnutt, ranked all the stocks in his universe by their past price performance and contrasted the relative strength and relative weakness of each. He also had a ranking system for 37 industry groups. Chestnutt explained that **the next logical step is to choose the best-performing stocks from the best performing industries.**

In a 1980 *Institutional Investor* article, Chestnutt explained that he has little use for Wall Street research — "it's garbage input and garbage output."

Many things on Wall Street change over time, but one thing that does not change is the propensity for the cumulative effects of buying and selling to create price trends. While Chestnutt surely did not outperform every single year, he employed a disciplined relative strength strategy that served his investors well over many years.

## Sentiment: On the Analyst's Couch

The AAI Sentiment Survey measures the percentage of individual investors who are bullish, bearish, and neutral on the stock market short term; individuals are polled from the AAI Web site on a weekly basis. Results as of 5/9/07.



43 percent were bullish and 43 percent were bearish. The long term average bullish reading is 39% and the long term average bearish reading is 28%. It is somewhat baffling that there is still above average pessimism given the great run in the market in recent months. **However, such pessimism is generally good for the market.**

## Other RS Sources

Relative Strength investing has a long history of well-documented testing. Some of the best known resources in the area are:

**What Works On Wall Street**, James P. O'Shaughnessy, McGraw Hill, 1997.

*Earnings Growth, P/Es and Relative Price Strength*, Robert A. Levy and Speros L. Kripotos, Financial Analysts Journal, 1967

*Eight Relative Strength Models Compared*, John S. Brush, Journal of Portfolio Management, 1986.

*Momentum Strategies*, Louis K.C. Chan, Narasimhan Jegadeesh, and Josef Lakonishok, Journal of Finance, 1996.

## Media Center

### Powershares DWA Technical Leaders ETF (PDP)

- Getting Technical With New ETF, *Investopedia*, April 26, 2007  
<http://tinyurl.com/35f8ch>
- Technical ETF, *ETF Topics*  
<http://tinyurl.com/2gozlb>
- New ETF follows trends based on technical factors, *CBS Marketwatch*, Mar 2, 2007  
<http://tinyurl.com/2qt6cd>
- New ETFs start trading on the NYSE, AMEX, *Reuters*, Mar 1, 2007  
<http://tinyurl.com/2uw4mu>

### Arrow DWA Balanced Fund (DWA FX)

- Fund of ETFs Leads Way for Moderate Allocation, *Arrow Funds*, Feb 21, 2007  
<http://tinyurl.com/2j56ow>

### General

- Can Relative Strength Be Used in Portfolio Management?, *Technical Analysis of Stock & Commodities*, Aug 2005  
<http://tinyurl.com/38ooq3>
- Systematic Relative Strength Investment, *The Wall Street Transcript*, Jan 29, 2007  
<http://tinyurl.com/2m7cls>

## To Request Info

To request information about our Systematic Relative Strength accounts, please call us at 626-535-0630, or e-mail us at [moneymanagement@dorseywright.com](mailto:moneymanagement@dorseywright.com)

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