Dorsey Wright & Associates Money Management

# High RS Newsletter

July 10, 2007 Issue 9

***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

$$u(t,x) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^{\infty} F(\xi) e^{-\alpha\xi^2 t} e^{i\xi x} d\xi,$$

Is the secret to stock market performance found in complex mathematical equations that evaluate a multitude of variables? Many think so…

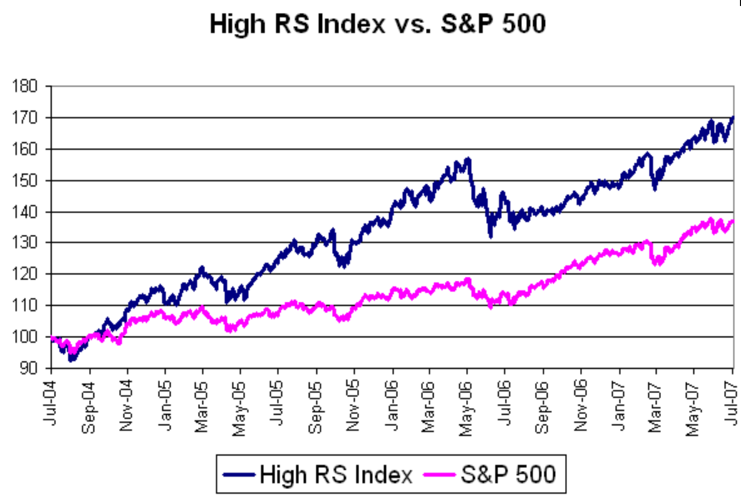
What if the stock market was logical? One would be able to uncover relationships that would lead to guaranteed profits. For example, what if it could be determined that every time the Fed lowers interest rates three consecutive times **and** a Republican is in the White House **and…,** the stock market would rise by 20 percent over the next 6 months.

In light of this question, consider the recent comments by Clay Allen, CFA: "There seems to be little doubt that the stock market qualifies as an complex adaptive system. The forces that contribute to the movements of the stock market are complex and hard to fathom. In one period, a certain variable can produce a certain outcome and in another period, the same movement of exactly the same variable may produce a completely opposite outcome. This is made even more complex by the fact that the relationships that tie the independent variables together are in a constant state of flux. **The changing influence of variables and their relationships to the price of stocks seems to suggest that a mathematical solution to the problem of producing performance in the stock market is probably impossible.**

And thus the need for an adaptable method of security analysis, such as relative strength.

## High RS Asset Class:

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 7/9/07:




"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 7/9/07

### Sector Performance

| S&P 500 GICS Sector | 12 Month | 6 Month | 1 Month |
|---|---|---|---|
| Telecommunications | 35.22% | 17.51% | -0.71% |
| Materials | 31.28% | 21.04% | 3.51% |
| Energy | 30.97% | 29.06% | 6.61% |
| Technology | 30.63% | 9.41% | 4.13% |
| Utilities | 22.81% | 10.60% | 1.98% |
| Consumer Discretionary | 21.69% | 3.96% | 1.73% |
| Industrials | 19.50% | 12.20% | 3.30% |
| Health Care | 16.99% | 5.55% | -0.60% |
| Financials | 12.86% | -0.40% | -1.46% |
| Consumer Staples | 12.47% | 4.29% | -0.36% |

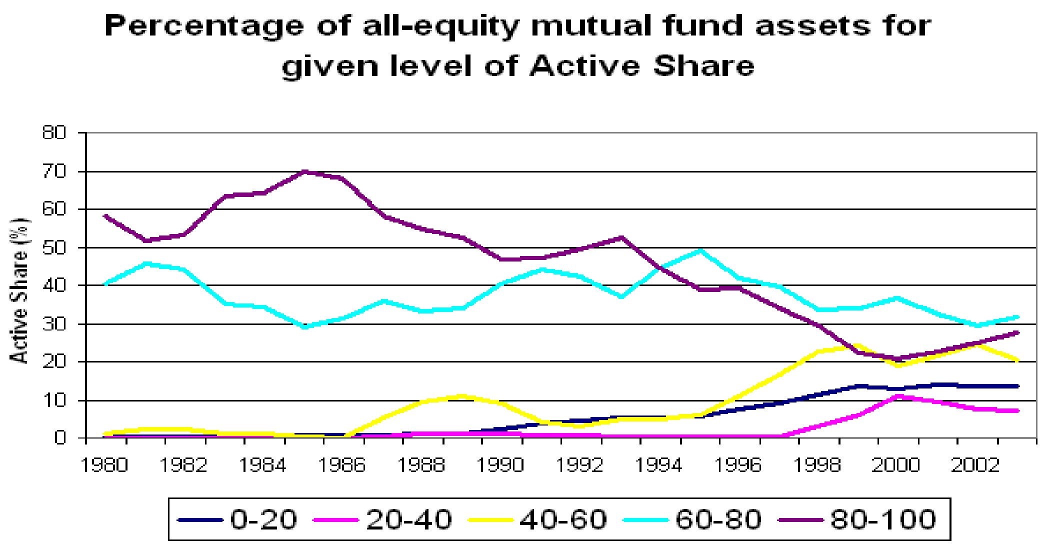
### Performance by Capitalization

| | | | |
|---|---|---|---|
| S&P Large-Cap | 20.92% | 8.44% | 1.36% |
| S&P Mid-Cap | 20.87% | 14.34% | 0.51% |
| S&P Small-Cap | 19.43% | 11.94% | 2.17% |

# Active Share

You are probably familiar with the term, "closet indexing." While professing to have an active management style, "closet-indexers" position their holdings to largely mimic the return of the benchmark. It is true that they may never look too bad, but they will also never look too good either. The returns of "closet-indexers" will never be notably different than the benchmark return. Such an approach to investing has never been popular at Dorsey Wright. We want to be great, and that means doing things differently. The study discussed below supports the contention that an active investment approach can be well rewarded.

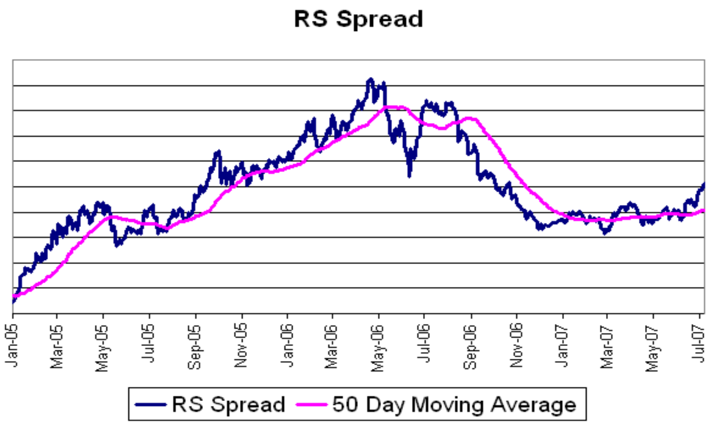
Two professors at Yale University have developed a simple way of measuring to what degree a fund's holdings are actively managed, as opposed to passively mirroring an index. It also turns out, according to their research, that this measure can be a useful predictor of fund performance. The new measure, created by Antii Petajisto and Martijn Cremers from Yale School of Management, takes a simple approach. This approach is called "Active Share" of a portfolio. It is calculated by matching the holdings reported by a fund in Securities and Exchange Commission filings against the components of an index, and then measuring the percentage of overlap. The more a portfolio differs from an index, the higher the active share percentage. **The study found that the average large cap fund, using the S&P 500 as a benchmark, has an average active-share percentage of 66%.** In other words, the average large-company stock fund had a portfolio that was 66% different than the benchmark and the rest essentially mirrored the index. The study examined data from 1980 through the end of 2003. Below is a chart from their study that shows the trend of the percentage of all-equity mutual fund assets for a given level of Active Share for the last two decades. The authors classify funds with an active share of 0-20 as pure index funds and those from 20 through 60 as "closet-index" funds.




It is startling to see how the fund business has changed over the last two decades. The 1980's were truly a time for active management, but it has become more important over the years to not deviate too far from the benchmark. The move toward more passive investment has important implications for investors. In order to provide returns-after fees-above the benchmark the manager must generate returns well above the benchmark. The more passive your portfolio becomes the more your returns will look like the benchmark, and consequently, the harder it will be for you to outperform. The data provided in the author's paper supports this. **On a net basis, they found only the managers with the highest levels of Active Share (80-100) were able to outperform over time. As of July 2007, our Systematic Relative Strength Aggressive account has an Active Share of 97.1%, our Core account an Active Share of 96.4%, and the Powershares DWA Technical Leaders Index (PDP) has an Active Share of 93.9%.** It is very difficult to manage a portfolio with high Active Share because the portfolio is often out of synch with the benchmark. Because of the obsession with short-term performance, it takes an extremely disciplined manager to look beyond the short-term volatility and continue to execute an active strategy that he or she believes will deliver superior results over time.

## RS Spread

The chart below is the spread between the relative strength leaders and the relative strength laggards (universe of mid and large cap stocks). When the chart is rising, relative strength leaders are performing better than relative strength laggards. When investors are confident in market leadership, they continue to buy into strength and sell into weakness. When investors are risk averse, they tend to sell into strength and buy into weakness. As of 7/9/07.




RS leaders have seen notable improvement.

## 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)

- Technical Leaders ETF Buys Strongest Charts, *Investors Business Daily,* June 15, 2007
  http://tinyurl.com/yrho94
- Getting Technical With New ETF, *Investopedia,* April 26, 2007
  http://tinyurl.com/35f8ch
- New ETF follows trends based on technical factors, *CBS Marketwatch,* Mar 2, 2007
  http://tinyurl.com/2qt6cd

Arrow DWA Balanced Fund (DWAFX)

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

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- 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

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