

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.

Another Nail in the Coffin

...of the Efficient Markets Hypothesis (EMH). As you recall, the EMH asserts that the financial markets are "informationally efficient". That is, one cannot earn returns in excess of average market returns using just publicly available information (like price). However, rather than random walking, sector funds seem to outperform the market when rotated according to a relative strength (momentum) criterion. After performing [a simple study](#), *CXO Advisory concludes:*

In summary, simple sector ETF momentum strategies have generally outperformed the broad stock market over the past decade for reasonably low trading frictions.

But wait, there's more:

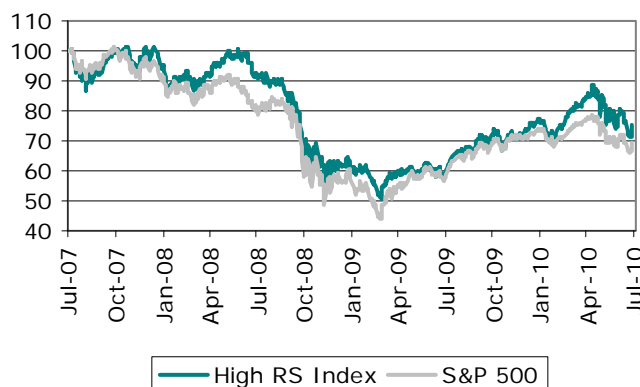
Including ETFs representing other asset classes (such as bonds, commodities, equity styles and international stocks) may enhance results.

That is essentially the recipe for our Global Macro separate account and the two Arrow Funds we sub-advise. Our own [white paper on asset class rotation](#) found the same thing. Relative strength just tries to go where the returns are. The evidence shows that often those returns persist.

High RS Asset Class

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 7/9/2010:

High RS Index vs. S&P 500



"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

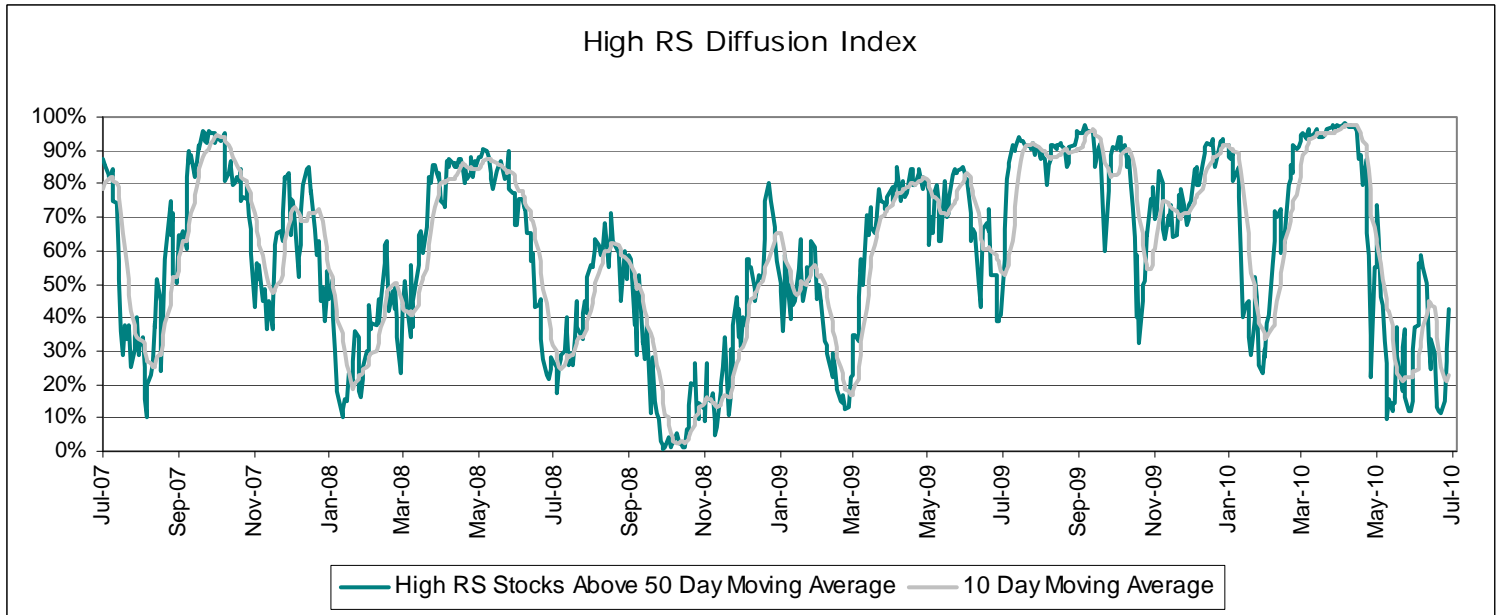
As of 7/9/2010

Sector Performance			
S&P 500 GICS Sector	12 Month	6 Month	1 Month
Industrials	38%	-3%	2%
Consumer Discretionary	37%	0%	-2%
Financials	29%	-5%	4%
Materials	26%	-12%	4%
Technology	25%	-8%	2%
Consumer Staples	14%	-1%	1%
Health Care	12%	-9%	3%
Energy	12%	-13%	2%
Utilities	10%	-3%	6%
Telecommunications	7%	-6%	1%

Performance by Capitalization			
S&P	12 Month	6 Month	1 Month
Mid-Cap	35%	-2%	2%
Small-Cap	32%	-1%	2%
Large-Cap	22%	-6%	2%

High RS Diffusion Index

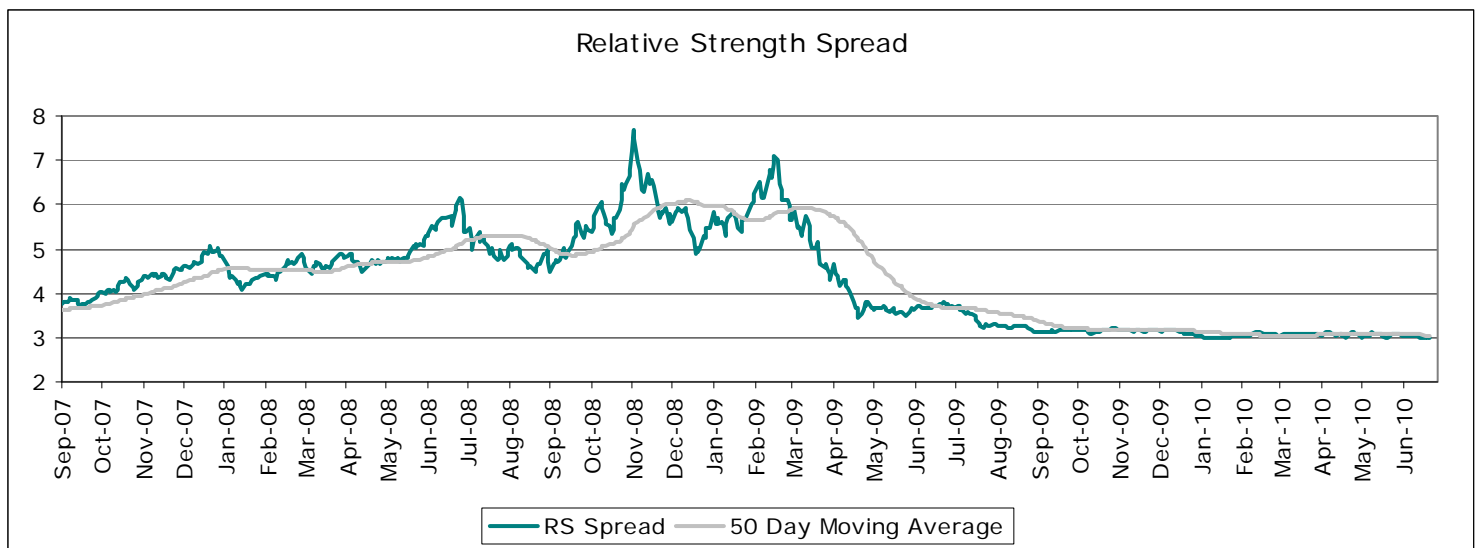
As of 7/9/2010



The 10-day moving average of this indicator is 23% and the one-day reading has now risen to 42% after spending the last two months in deeply oversold territory. Dips in this indicator have often provided good opportunities to add to relative strength strategies.

RS Spread

The chart below is the spread between the relative strength leaders and 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. As of 7/9/2010:



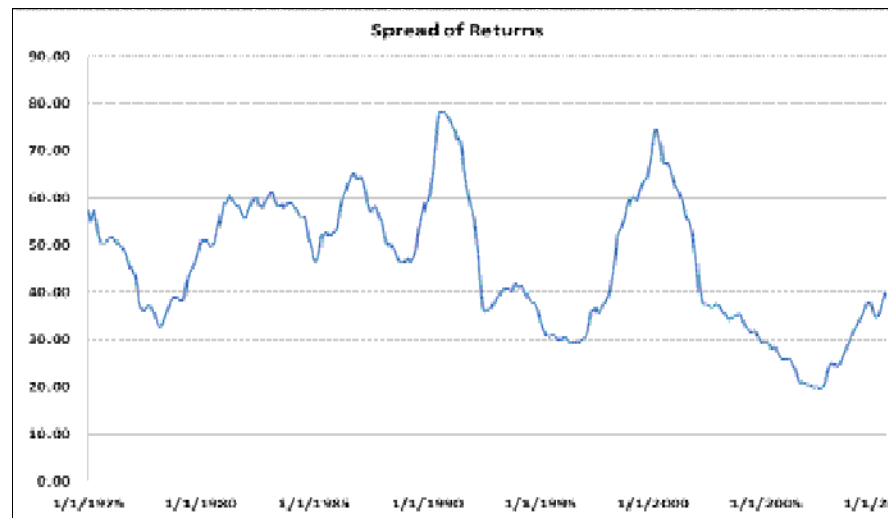
What is likely to follow this transitional phase of the Spread over the past year? I suspect that we are setting the stage for a very favorable environment for RS investing in the coming years.

The Great Divergence

Bill Hester, CFA of Hussman Funds recently wrote a very [insightful article](#) about the convergence of the global financial market performance that began in the second half of the 1990s which has turned into growing divergence in recent months:

*For a brief period during the last decade the developed economies around the world became one. Countries shared similar fiscal policies, interest rate policies, and spending patterns which resulted in uncharacteristically similar economic performances. Investors took their cues from these trends and sent financial market securities converging in price and yield. The range of bond yields tightened, the level of valuations became closely aligned, and trailing stock returns were remarkably similar. As the developed economies continue to recover from the world-wide credit crisis, and now face new pressures of over-levered sovereign balance sheets and the prospects for below-average economic growth, **investors should expect financial market performance among countries to continue to diverge.** (Bold is my emphasis)*

Included in his article was the graph below which shows the spread between the highest and lowest 6-month returns of the members of Morgan Stanley's index of developed countries (the spread is smoothed to highlight the medium-term cyclical fluctuations of the series).



(Click to Enlarge)

Hester's article discusses the events and policies that have contributed to the periods of convergence and to the periods of divergence in country stock market performance over the last several decades.

These trends have shifted the last couple of years and the recent spread between relative performances continues to widen. Year to date, Denmark's benchmark index is up 20 percent, while the Athens Stock Exchange index has dropped 33 percent. Country selection is beginning to matter again.

This growing divergence is potentially a very favorable development for global relative strength strategies. In any universe of securities there is a dispersion or bell curve of returns with the bulk of the returns huddled around the mean and then a number of extreme positive outliers and a number of extreme negative outliers. The goal of relative strength strategies is to focus the portfolio on the positive outliers and to avoid the extreme negative outliers. **The greater the dispersion in returns, the more likely relative strength is to be able to deliver superior performance over a benchmark index fund.** If we do indeed see much greater divergence in country returns going forward, relative strength is well-positioned to capitalize.

Fund Flows

The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Flow estimates are derived from data collected covering more than 95 percent of industry assets and are adjusted to represent industry totals. The table below is ranked in descending order based on flows for the week ending 6/30/2010. *Millions of dollars*

	6/30/10	YTD
Taxable Bonds	4,265	139,506
Municipal Bonds	558	19,587
Hybrid	94	13,929
Foreign Equity	47	26,608
Domestic Equity	-227	-18,979

Taxable bonds continue to be the asset class of choice among retail mutual fund investors.

Other RS Sources

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

Brush, John S. "Eight Relative Strength Models Compared." Journal of Portfolio Management (1986).

Berger, Israel, Moskowitz. "The Case for Momentum Investing." AQR Capital Management. 2009.

Jegadeesh and Titman. "Returns to Buying Winners and Selling Losers." Journal of Finance (1993).

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

Media Center

Powershares DWA Technical Leaders ETFs (PDP, PIE, and PIZ)

- [Four Alpha-Seeking ETFs Crushing SPY, ETFdb](#), Apr 30, 2010
- [Under the Microscope: Powershares DWA Technical Leaders ETF, Seeking Alpha](#), Mar 31, 2010

Arrow DWA Balanced Fund (DWAFFX)

- [The Arrow DWA Balanced Fund](#), Jun 17, 2010

Arrow DWA Tactical Fund (DWTAFX)

- [The "All-in-One Fund" With a Twist](#), Jun 16, 2010

Dorsey Wright Money Management

- [Bringing Real-World Testing To Relative Strength](#), Jan 2010
- [Relative Strength and Asset Class Rotation](#),

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To Request Info

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

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