

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

Bat Like Babe Ruth

Would you rather invest in a portfolio in which more than half the stocks go up, or one in which only 40% of the stocks go up? Well, if you chose the former, you wouldn't be alone, but you might not end up any wealthier. The reason you wouldn't be alone is that people want to avoid losses--so much so that they often feel more pain from losing money than satisfaction from gaining an equal amount of money. The portfolio with fewer winners, however, could have included a few stocks that rose dramatically in value, which frequently results in better overall performance.



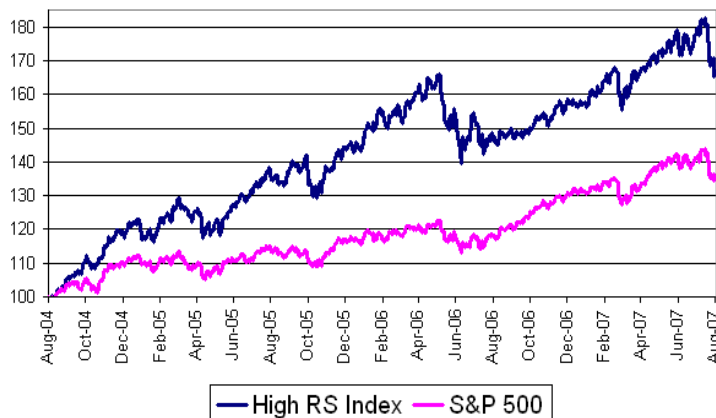
This is what Michael Mauboussin, chief investment strategist at Legg Mason Capital Management, refers to in his book, *More Than You Know*, as the Babe Ruth effect: Even though Ruth struck out a lot, he was one of baseball's greatest hitters. From 1918 to 1934, Ruth led the American League in batting average just once and finished either first or second in strikeouts in 12 of those years. However, the hall-of-famer finished first in slugging percentage (calculated by total bases divided by at bats) for 13 consecutive years due to his home-run-hitting prowess.

Likewise, a relative strength strategy forces you to cut out all the losers and hold on to the winners. It is not uncommon for the majority of your return to come from a few big winners.

High RS Asset Class:

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 8/6/07:

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 8/6/07

Sector Performance

| S&P 500 GICS Sector | 12 Month | 6 Month | 1 Month |
|------------------------|----------|---------|---------|
| Technology | 31.08% | 8.40% | -1.97% |
| Telecommunications | 26.62% | 8.82% | -1.61% |
| Materials | 24.86% | 5.25% | -6.42% |
| Industrials | 23.28% | 9.03% | 0.31% |
| Energy | 17.35% | 14.02% | -5.86% |
| Utilities | 15.32% | 3.61% | -1.71% |
| Consumer Discretionary | 13.86% | -6.90% | -7.98% |
| Consumer Staples | 10.66% | 2.90% | 0.15% |
| Health Care | 8.45% | -0.39% | -3.24% |
| Financials | 1.45% | -10.29% | -8.07% |

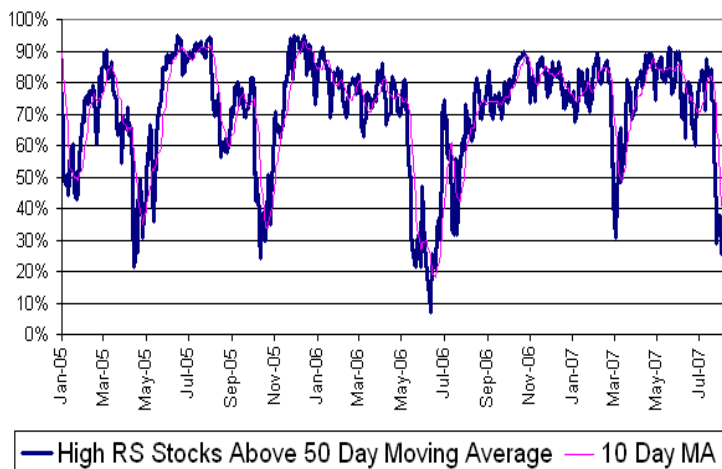
Performance by Capitalization

| | | | |
|---------------|--------|--------|--------|
| S&P Large-Cap | 14.05% | 0.91% | -4.43% |
| S&P Mid-Cap | 13.66% | -0.08% | -7.31% |
| S&P Small-Cap | 11.59% | -1.90% | -7.77% |

High RS Diffusion Index

As of 8/6/07

Dorsey Wright Diffusion Index

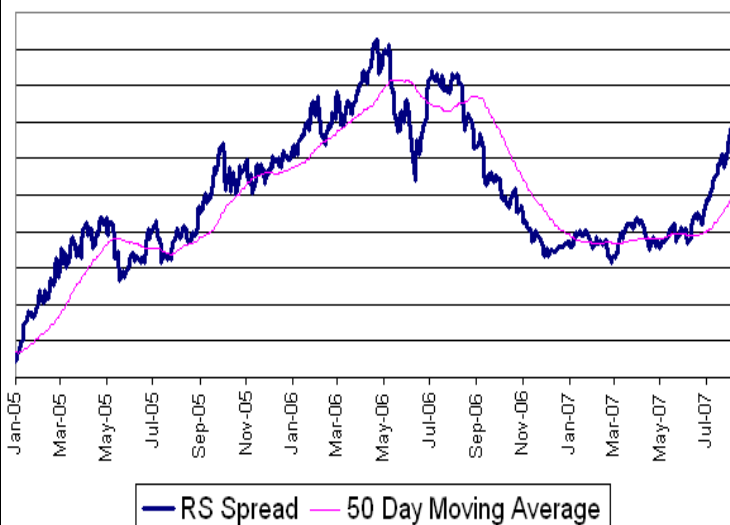


Dips in this indicator have historically provided good opportunities to add money to relative strength strategies. The low for the year of this indicator is a reading of 25, which occurred on 8/3/07. As can be seen from the chart, this indicator often spikes off the bottom, but lingers at the top for extended periods of time.

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. 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 8/6/07

Relative Strength Spread



Adding Risk to Reduce Risk

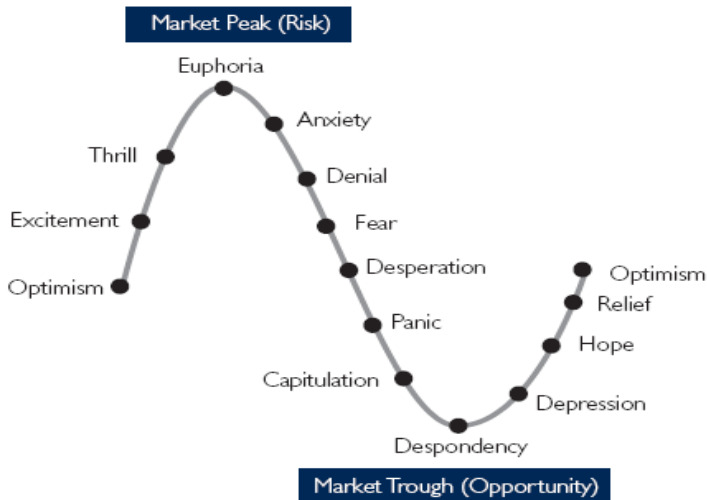
A counterintuitive proposition is one that does not seem likely to be true when assessed using intuition or gut feelings. However, just because it is counterintuitive does not mean it is not true. For example, to anyone who stands and looks at the sky, it seems clear that the earth stays in one place while the Sun rises and sets once every day. Yet, it is the Earth that orbits the Sun. To lose weight, eat more frequently not less (just smaller quantities). And to reduce risk to an overall portfolio, you can add risk (assuming a less-than-perfect correlation between assets). The equation to calculate the standard deviation of a portfolio is **not** just a weighted average of the standard deviations of the assets. **The process must also include the correlation as shown in the formula below.**

$$\text{Portfolio variance: } \sigma_p^2 = w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + 2w_A w_B \rho_{AB} \sigma_A \sigma_B$$

Consider the following hypothetical example. Assume Manager A has a standard deviation of 9% and an expected return of 18%. The other asset in the portfolio is the S&P 500 which has a standard deviation of 8% and an expected return of 10%. The correlation between Manager A and the S&P 500 is 0.76. Consider the impact on overall portfolio risk for the investor who invests 20% of his portfolio in Manager A and 80% in the S&P 500. If portfolio risk were calculated as a simple weighted average of the standard deviations of each asset (incorrect method), one would conclude that the portfolio risk would be 8.2%. Perhaps to some it would seem intuitive that by investing 20 percent of the portfolio with Manager A, risk would be increased as compared to a portfolio 100% invested in the S&P 500. However, the correct method of calculating portfolio risk involves a consideration of the correlation of Manager A to the S&P 500. When calculated using the formula above, one finds that the portfolio risk has actually decreased to 7.86%. Additionally the expected return of the portfolio has just increased from 10% to 11.6%!

It is common for relative strength strategies to have higher standard deviation than the S&P 500. Looking at that alone, one could be led to believe that portfolio risk is increased by adding a relative strength strategy to a portfolio. However, correlation must also be considered. To receive the correlation of our Systematic Relative Strength accounts to the S&P 500, just send an e-mail to andyh@dorseywright.com.

Sentiment Update



Sometimes, it is difficult to gauge prevailing market sentiment; other times it is easier. Where does Jim Cramer currently fall? <http://www.youtube.com/watch?v=wtjkWJzxdQU> Okay, maybe it's a stretch to say that Cramer represents prevailing market sentiment, but at a minimum it underscores the rising level of panic if not despondency...which presents opportunity.

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 (DWAFF)

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

Dorsey Wright Money Management

- 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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