

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.

In Search for Objective Reality

Barry Ritholtz of *The Big Picture* blog recently wrote an [intriguing essay](#) detailing his approach to "seeking the truth." He defined truth as "being in accord with objective reality." His motivation for seeking truth was as follows: "It is intellectually stimulating, and it can be profitable." The motivation for other truth seekers could include those reasons as well as many others.

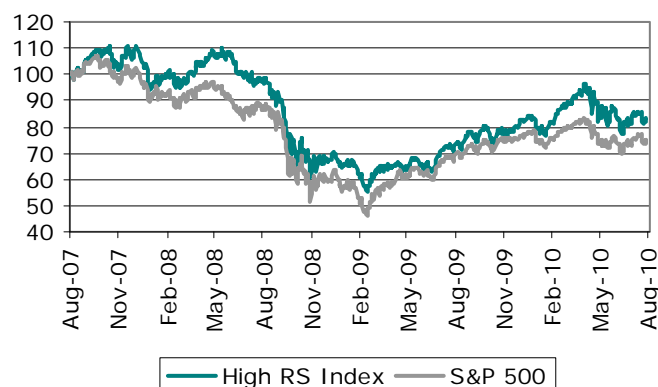
As part of his essay he also explored the motivations for those who seek to obscure the truth: "But what motivates people to pursue a narrative that is blatantly false, misleading or intellectually dishonest? Typically, it meets a powerful group's specific agenda. There is an embedded interest amongst the powerful to preserve the *status quo*. The thought process seems to be, 'Hey, it's working for us, let's not mess up a good thing.'"

In the context of investing, how does an investor determine which analysts, economists, CEOs, etc. can be believed and which may be obscuring the truth? The reality is that it can be nearly impossible to tell. However, one of the major benefits of systematic relative strength models is that the input to the model is a single, objective data point: price. That price is simply a reflection of the supply and demand relationship for a given security. Furthermore, price reflects the collective judgment of all market participants. **No longer is an individual investor in the position of trying to determine truth from untruth. Rather, the focus becomes capitalizing on the trends of the collective judgment of all market participants.**

High RS Asset Class

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 8/19/2010:

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

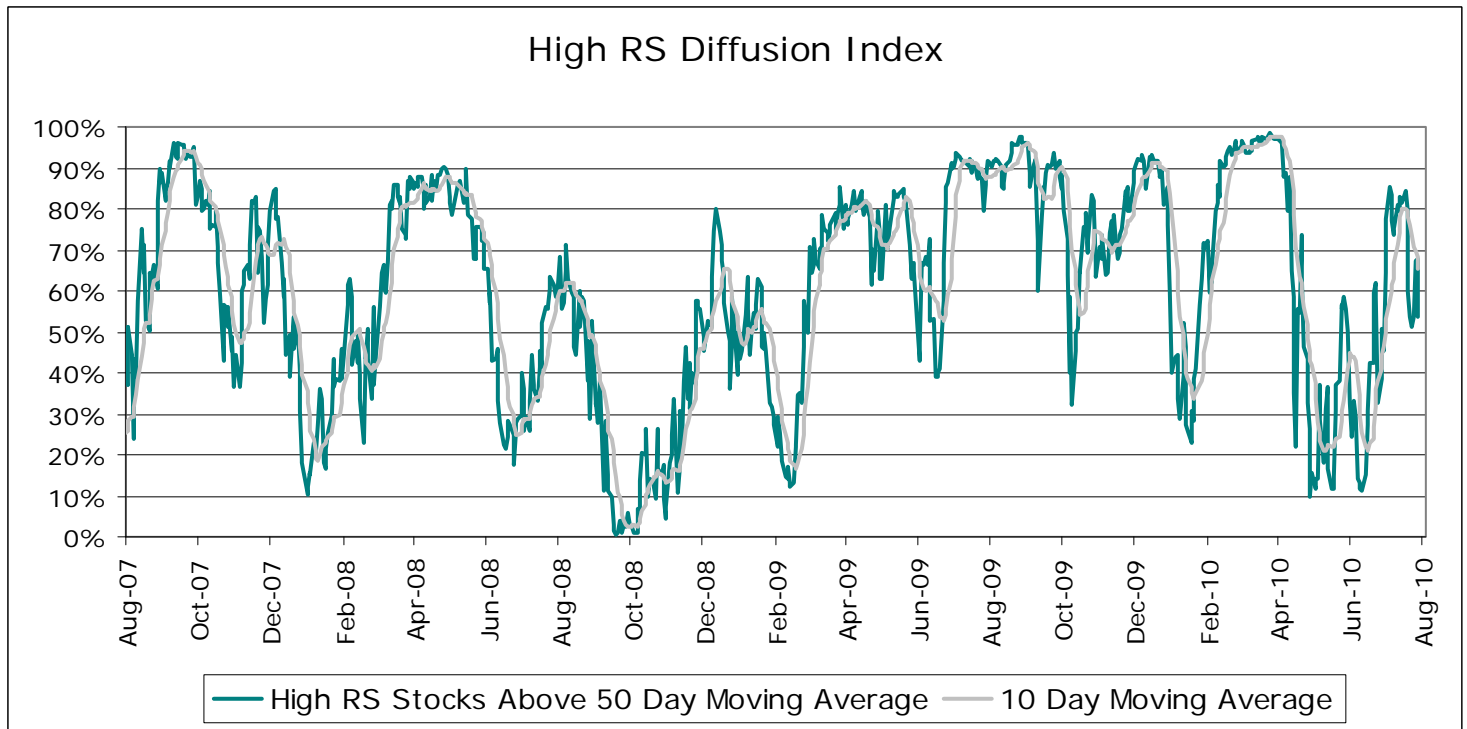
As of 8/19/2010

Sector Performance			
S&P 500 GICS Sector	12 Month	6 Month	1 Month
Consumer Discretionary	21%	2%	2%
Industrials	20%	1%	4%
Consumer Staples	10%	-2%	1%
Telecommunications	9%	9%	8%
Technology	9%	-4%	-3%
Materials	8%	-2%	5%
Utilities	5%	2%	0%
Energy	2%	-7%	1%
Health Care	2%	-9%	0%
Financials	0%	-4%	-2%

Performance by Capitalization			
S&P Mid-Cap	12 Month	6 Month	1 Month
S&P Mid-Cap	15%	0%	1%
S&P Small-Cap	10%	-2%	-1%
S&P Large-Cap	8%	-3%	1%

High RS Diffusion Index

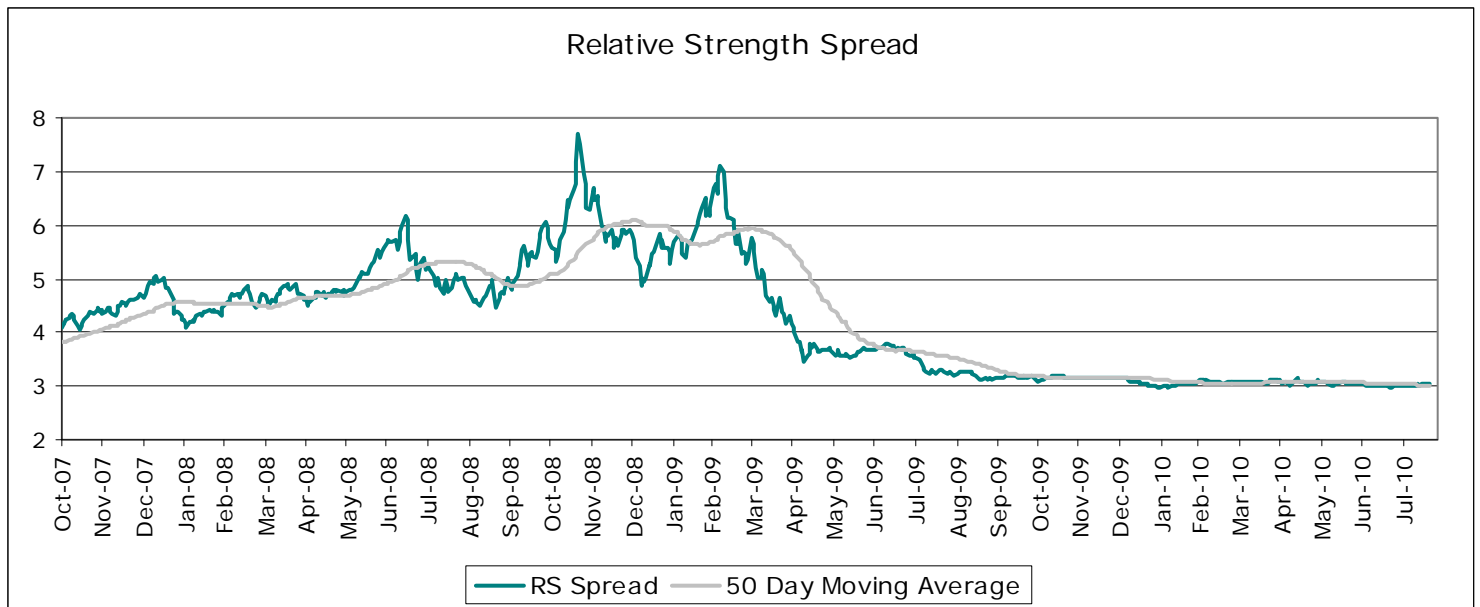
As of 8/19/2010



The 10-day moving average of this indicator is 65% and the one-day reading is 54%. After snapping back strongly in July, this indicator is now pulling back to the middle of the distribution.

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 8/19/2010:



RS leaders and laggards continue to mark time without either one substantially distinguishing itself from the other in terms of performance. This transition from a declining spread to what may well be a period of a rising spread has now lasted for over a year.

Jeremy Siegel: "The Great American Bond Bubble"

Jeremy Siegel - March 14, 2000

On March 14, 2000 Professor Jeremy J. Siegel of the Wharton School penned an article in the *WSJ* titled "[Big-Cap Tech Stocks Are a Sucker Bet](#)" in which he argued that tech stocks were overvalued and should be avoided:

Until yesterday's sell-off the Nasdaq Stock Market had enjoyed quite a run, surpassing 5000 for the first time even as the Dow Jones Industrial Average went through a correction. But are the high valuations of the tech stocks that drive the Nasdaq index justified? History Suggests not.

Included in that article was the following chart. Look at those P/E ratios!

COMPANY	MARKET CAP (3/7/00, in bil.)	1999 P/E	EST. GROWTH	P/E IN 5 YRS.	P/E IN 10 YRS.
Cisco Systems	\$452	148.4	29.5%	73.9	40.9
AOL/Time Warner	232	217.4	31.5	100.0	51.1
Oracle	211	152.9	24.9	91.3	60.5
Nortel Networks	167	105.6	20.7	74.5	58.4
Sun Microsystems	149	119.0	21.1	82.8	64.0
EMC	130	115.4	31.1	54.0	28.1
JDS Uniphase	99	668.3	44.0	195.5	63.5
Qualcomm	91	166.8	37.3	61.8	25.5
Yahoo!	90	623.2	55.9	122.6	26.8
15 non-tech	2,361	30.4	13.7	23.8	20.3
S&P 500	11,281	28.6	12.5	23.8	21.3

Source: Bloomberg

Siegel continued:

Many of today's investors are unfazed by history--and by the failure of any large-cap stock ever to justify, by its subsequent record, a P/E ratio anywhere near 100.

What does all this mean? Our bifurcated market has been driven to an extreme not justified by any history. The excitement generated by the technology and communications revolution is fully justified, and there is no question that the firms leading the way are superior enterprises. But this doesn't automatically translate into increased shareholder values.

Professor Siegel's call turned out to be prescient. **As of this writing the Nasdaq index remains 56% below its value of 5,048.62 achieved just days before Siegel's article appeared in the *WSJ* over 10 years ago.**

Jeremy Siegel - August 18, 2010

Well, Professor Siegel is at it again with his article, "[The Great American Bond Bubble](#)" in the August 18, 2010 *WSJ*. My emphasis added.

Ten years ago we experienced the biggest bubble in U.S. stock market history—the Internet and technology mania that saw high-flying tech stocks selling at an excess of 100 times earnings. The aftermath was predictable: Most of these highfliers declined 80% or more, and the Nasdaq today sells at less than half the peak it reached a decade ago.

Jeremy Siegel: "The Great American Bond Bubble"

A similar bubble is expanding today that may have far more serious consequences for investors. It is in bonds, particularly U.S. Treasury bonds. Investors, disenchanted with the stock market, have been pouring money into bond funds, and Treasury bonds have been among their favorites. The Investment Company Institute reports that from January 2008 through June 2010, outflows from equity funds totaled \$232 billion while bond funds have seen a massive \$559 billion of inflows.

We believe what is happening today is the flip side of what happened in 2000. Just as investors were too enthusiastic then about the growth prospects in the economy, many investors today are far too pessimistic.

Those who are now crowding into bonds and bond funds are courting disaster. *The last time interest rates on Treasury bonds were as low as they are today was in 1955. The subsequent 10-year annual return to bonds was 1.9%, or just slightly above inflation, and the 30-year annual return was 4.6% per year, less than the rate of inflation.*

Furthermore, the possibility of substantial capital losses on bonds looms large. If over the next year, 10-year interest rates, which are now 2.8%, rise to 3.15%, bondholders will suffer a capital loss equal to the current yield. If rates rise to 4% as they did last spring, the capital loss will be more than three times the current yield. Is there any doubt that interest rates will rise over the next two decades as the baby boomers retire and the enormous government entitlement programs kick into gear?

With future government finances so precarious, private asset accumulation and dividend income must become the major sources of retirement funding. At current interest rates, government bonds will not be the answer. One hundred times earnings was the tipping point for the tech market a decade ago. We believe that the same is now true for government bonds.

How long will the bond bubble go? I don't know. Last time Siegel made such a call he was within days of the top. Given the strength in bonds, many of our tactical asset allocation models currently own some bonds. However, I take great comfort in knowing that relative strength models have the flexibility to reduce or even eliminate (depending on the model constraints) any asset class that deteriorates and loses sufficient relative strength. As Siegel points out, all the investors who are giving up on other asset classes and piling into bonds for their perceived safety may well be sorely disappointed in the coming years and decade.

HT: Joel Chitrea

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 8/1/2010. *Millions of dollars*

	8/11/10	YTD
Taxable Bonds	5,788	172,434
Municipal Bonds	1,382	25,087
Foreign Equities	646	28,057
Hybrid	213	13,320
Domestic Equity	-2,073	-35,976

The story of the year, in terms of asset flows, has been \$172 billion into taxable bond funds and \$36 billion out of domestic equity funds.

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](#), Mar 2010

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