

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

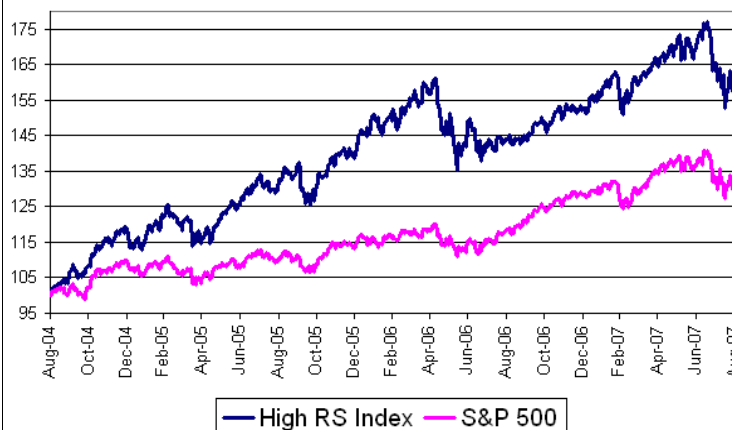
Is there a price at which each stock SHOULD trade? If the answer is yes, then the key to profitable investing is to simply calculate the "fair" value of each stock. Those that are undervalued should be bought and those that are overvalued should be sold short. The result would be risk-free profits. The unfortunate corollary of this logic is that due to the arbitrage activity all prices would quickly revert to their equilibrium and no further excess returns would be possible. That is the basis for those (primarily academics) who believe that cap-weighted indexing is the most efficient investment strategy. One could disprove this theory by calculating the fair value of all stocks using a widely accepted valuation methodology and observing whether or not stocks revert back to their "fair" value.

Those of us employing relative strength subscribe to a different theory. Our theory is that there is no such thing as intrinsic value of a stock. Rather, it is simply supply and demand that determines the stock's price. Furthermore, the causes of that buying and selling pressure change over time. Sometimes investors are primarily influenced by the fundamentals of the company. At other times they are primarily influenced by industry or macroeconomic developments; at still other times investors are overcome with irrational exuberance. The list of influences goes on. The predominant reason for the buying and selling pressure is of little importance. An RS manager simply capitalizes on the differences in relative price movement.

High RS Asset Class:

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 8/31/07:

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 8/31/07

Sector Performance

S&P 500 GICS Sector	12 Month	6 Month	1 Month
Energy	26.72%	22.78%	0.55%
Materials	23.70%	5.05%	-0.78%
Telecommunications	23.59%	7.62%	-0.08%
Technology	22.78%	13.29%	2.74%
Industrials	21.07%	11.01%	-0.20%
Consumer Discretionary	12.95%	-2.99%	0.24%
Utilities	11.58%	0.62%	1.83%
Consumer Staples	6.44%	3.68%	2.47%
Health Care	5.35%	2.43%	2.27%
Financials	1.08%	-6.21%	1.26%

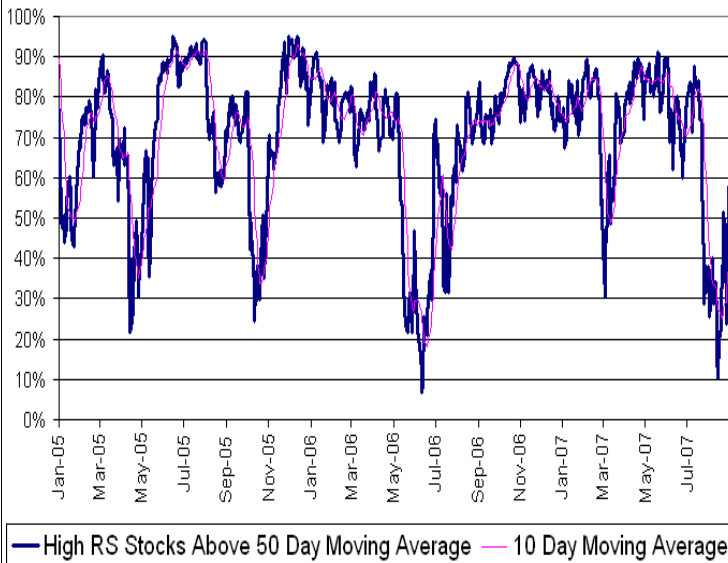
Performance by Capitalization

S&P Mid-Cap	14.65%	2.52%	1.13%
S&P Small-Cap	13.23%	2.98%	1.81%
S&P Large-Cap	12.97%	4.73%	1.28%

High RS Diffusion Index

As of 8/31/07

Dorsey Wright Diffusion Index

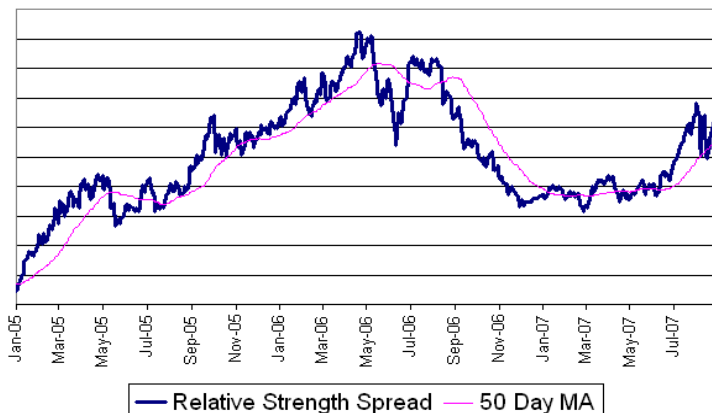


On August 16, this indicator reached a low of 10 percent, but has since snapped back sharply. High relative strength stocks are coming back very strongly from the recent correction.

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 8/31/07

Relative Strength Spread



The spread is in a rising trend indicating high relative strength outperformance.

Asset of Choice for the Long Run

Rising market volatility over the past couple months may make some wonder why they even bother with equities at all. Why not just choose the safety of T-Bills? Those who may need a little reassurance should consider some research completed by Jeremy Siegel, Ph.D. about which asset class (among stocks, bonds, bills, gold, and the dollar) has been the most rewarding over the past 204 years.

"During the past 204 years (through 2005) stock investors have earned an average 6.8 percent per year after inflation and that return has been remarkably stable over long periods. Over the past 80 years, real stock returns averaged 6.7 percent per year, and since the end of the second World War, the annual return has been 6.8 percent. This return includes both capital gains and dividend income and is measured after the effects of inflation have been subtracted. These numbers mean that *on average*, investors' wealth has doubled in purchasing power every decade in stocks, a feat rivaled by no other asset class (Siegel, Jeremy March 9, 2006)."

Annual Stock Market Returns (Real Returns)

1946-2006	6.9%
1946-1965	10.0%
1966-1981	-0.4%
1981-1999	13.6%
1985-2006	8.6%

Annual Bond Market Returns (Real Returns)

1946-2006	1.4%
1946-1965	-1.2%
1966-1981	-4.2%
1981-1999	8.4%
1985-2006	5.8%

Furthermore, Siegel's research shows the real return of \$1 invested in each of the following from 1801-2006:

Stocks	\$754,511
Bonds	\$1,083
Bills	\$300
Gold	\$1.95
Dollar	\$0.06

Source: Siegel, Jeremy *Stocks for the Long Run*

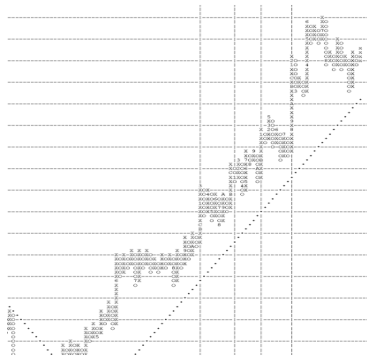
Clearly, the best performing asset class over time is stocks. This is just a reminder why tolerating stock portfolio volatility is worth it over time.

Sentiment Update

Bernie Schaeffer, of Schaeffer's Investment Research, recently commented on the combination of an overall rising trend in the equity market and bearish sentiment:

"This juxtaposition of bearish sentiment against bullish price action is the most powerful buy signal in my world, as it establishes that there is sideline money (and short-covering impetus) to drive the market much higher than players expect. In essence, it gives you as a trader "permission" to go with the trend and with price momentum."

Trend of S&P 500



The chart to the left shows the rising trend of the S&P 500. Also, note that investor sentiment as measured by the AAI survey shows that 46% are bearish (while the long-term average bearish reading is 28%).

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. Kriptomos, 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

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- 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

- Is a bottom in place?, *MarketWatch*, Aug 8, 2007
<http://tinyurl.com/3c6yoo>
- 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>

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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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