

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

The myth of efficient markets is often sustained by arguments such as "if a system works, then everyone will use it, and then it will stop working." I sometimes wonder if the proponents of such arguments have ever spent time among real human beings! "Everyone" won't stick to the system and therefore the market inefficiencies that such systems rely on are not arbitrated away. The reason that "everyone" won't stick to a winning long-term strategy is **because they can't always work in the short term**. In other words, investors buy into a given winning strategy, experience some period of time when the strategy underperforms, and exit the strategy thinking that the strategy is broken. I certainly am not complaining that investors often behave in this fashion. After all, it is that very irrational behavior that creates the opportunity for excess returns for those disciplined enough to stay the course. All successful systems are dependent upon human nature, which never changes.

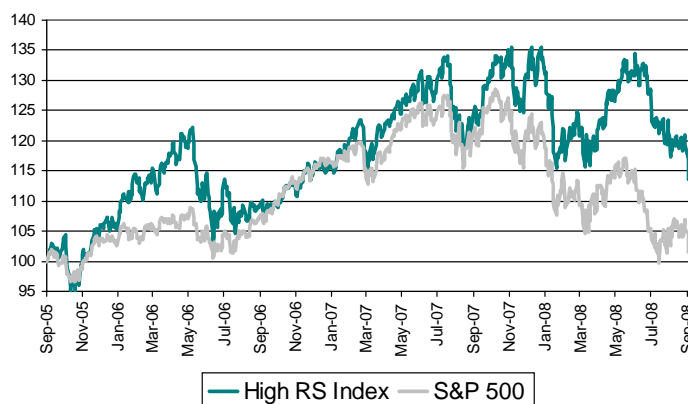
So what is the primary market inefficiency that relative strength strategies capitalize on?

Herding behavior: Investors tend to look to one another to confirm their own actions. The herd starts small and builds and builds until the trend reverses. RS capitalizes by identifying the dominant themes, overweighting the portfolio in those areas, and then being disciplined enough to exit once the trend has reversed. RS excels at getting in on the trend in the relatively early stages of the move, and then exiting when the trend has reversed. The undisciplined tend to get in late and ride losing positions down.

High RS Asset Class:

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 9/5/08:

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 9/5/08

Sector Performance

| S&P 500 GICS Sector | 12 Month | 6 Month | 1 Month |
|------------------------|----------|---------|---------|
| Consumer Staples | 5.77% | 2.42% | -0.05% |
| Materials | -5.69% | -11.72% | -3.33% |
| Energy | -5.85% | -11.09% | -4.14% |
| Health Care | -8.09% | -3.15% | -3.86% |
| Utilities | -9.23% | -8.54% | -4.73% |
| Industrials | -15.29% | -9.40% | -4.01% |
| Technology | -16.02% | -3.35% | -6.21% |
| Consumer Discretionary | -17.58% | -3.27% | 1.69% |
| Telecommunications | -24.64% | -7.03% | -0.23% |
| Financials | -35.30% | -13.64% | -4.00% |

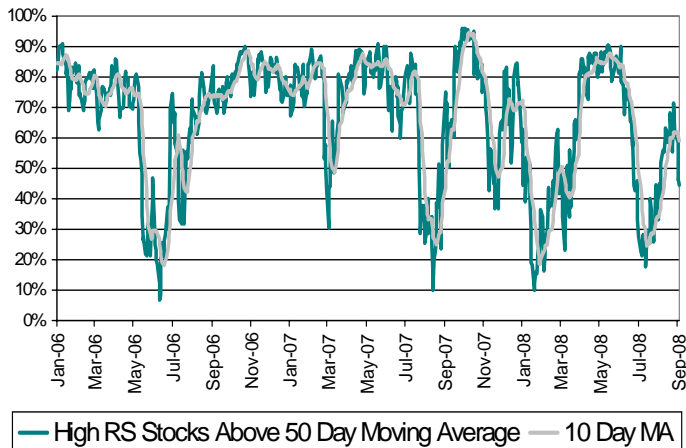
Performance by Capitalization

| | | | |
|---------------|---------|--------|--------|
| S&P Small-Cap | -9.43% | 3.97% | -0.26% |
| S&P Mid-Cap | -9.78% | -0.97% | -2.41% |
| S&P Large-Cap | -15.81% | -7.03% | -3.07% |

High RS Diffusion Index

As of 9/5/08

High RS Diffusion Index

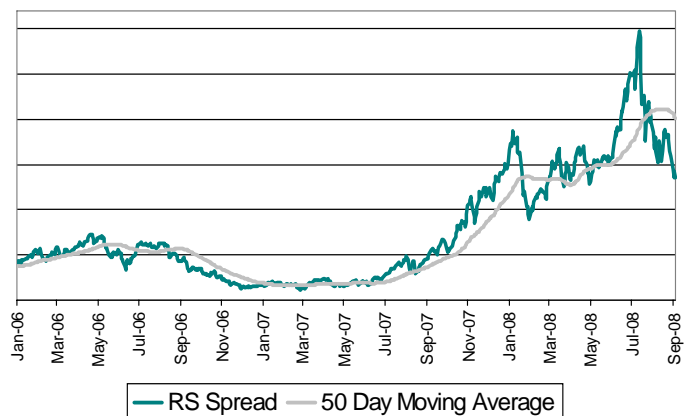


The 10 Day Moving Average of this Diffusion Index is now at 59%, while the one day reading is at 45%. We tend to take notice of this indicator when it reaches extreme oversold levels, as it does periodically.

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 9/5/08:

Relative Strength Spread



As often noted, the performance of RS strategies tends to be lumpy. While the long-term performance tends to be exceptional, it does experience short-term periods of underperformance, as seen for the last couple of months.

Why We Rely On Price



Recently, the *Washington Post* asked a number of smart people - inside and outside economics and finance -- to scan their bookshelves for answers to the current financial crises and stock market woes. Though there is no single book that can sum up and explain the current conditions, they asked each of their contribu-

tors for one book they would recommend to their neighbor, their daughter, their aunt, their barber, priest, rabbi or best friend to help them gain some perspective on these volatile times. They imposed only one rule: You cannot recommend a book you wrote or edited. After that, no rules. It could be a macro-economics text, a popular history or a novel. The list of those experts asked to contribute included the director of the Congressional Budget Office, a former U.S. Treasury Secretary, economic and law professors at Columbia and Harvard, CEOs and directors of corporations, among others. Mark Cuban, owner of the Dallas Mavericks, was also asked to contribute.

While there is surely knowledge and insight to be gained by the responses of the various contributors, I found Mark Cuban's response to be the most interesting. Cuban simply responded with: "No recommendation. I don't think there is such a book. In my humble opinion, people who actually believe they can understand all the issues are the ones that got us to where we are today. In reality, there are so many variables and so little data, it's all a guess. I don't think a book exists that can explain it. Is there a book out there called 'No One Has a Clue What Is Going On and the Whole World Is Guessing?'"

Cuban's conclusion is one that we agree with and a basis for why we rely on relative strength to manage portfolios. The reality is that nobody has all the answers of how we got into the current market woes, or the exact path that will be followed to get to better markets. As portfolio managers, rather than focus our efforts on uncovering the answers to the fundamentals behind the price moves, we choose to focus on the price moves (specifically the relative price moves) to determine our actions. Testing shows that this approach can be very rewarding.

Click [here](#) for an example of such research.

Investor Sentiment

Cash levels at quarter century highs.



Ratio of money market fund assets to the market value of the S&P 500

Source: Navellier Applied Research & Ned Davis Research

With the stock market currently struggling through a rough patch, it can be instructive to examine a ratio of cash levels (as measured with money market assets) relative to the market. The reason is that such a measure can help to identify the degree to which liquidity is available as fuel for market advances. In the three years following the prior peak on 7/31/1982, the stock market doubled.

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

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<http://tinyurl.com/3wnbxb>
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Seeking Alpha, April 23, 2008
<http://tinyurl.com/52qdt5>

Arrow DWA Balanced Fund (DWAFF)

- 2007 Lipper Performance Achievement
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Arrow DWA Tactical Fund (DWTFX)

- New Fund Targets Aggressive Investors, *Investment News*, July 14, 2008
<http://tinyurl.com/58aq9o>

Dorsey Wright Money Management

- Can Relative Strength Be Used in Portfolio Management?, *Technical Analysis of Stock & Commodities*, Sep 2005
<http://tinyurl.com/38ooq3>
- Systematic Relative Strength Investment, *The Wall Street Transcript*, April 21, 2008
<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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