Dorsey Wright & Associates Money Management

High RS Newsletter

September 18, 2007 Issue 14

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

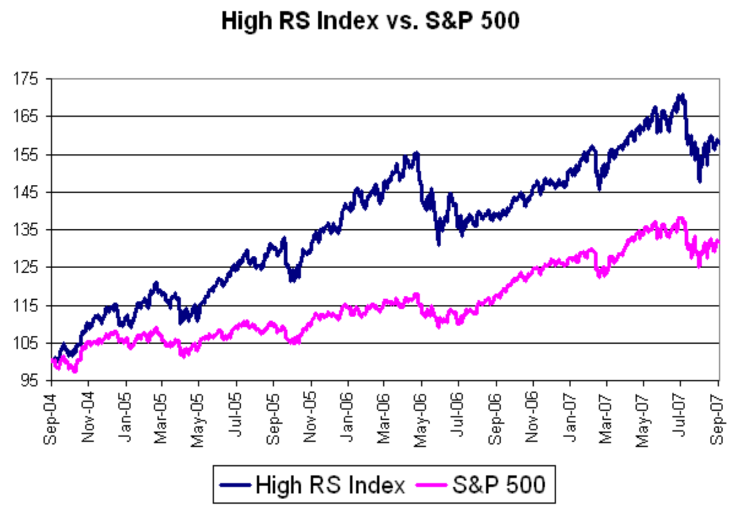
If you believe in technical analysis, you believe in trends. Trends are created by the "irrational" behavior of market participants. Consider the grocery store analogy: If you cut the price on beans 30% at the grocery store, shoppers buy more beans. That's what economists call rational behavior. If you mark IBM stock down 30%, everybody wants to sell their IBM. That is what creates trends, and why the tails are too fat on the bell curve that underlie "Modern Portfolio Theory."

As technicians, we are actually studying the psychology of the marketplace. Our tools allow us to recognize irrational behavior (a trend). It is rational for us to take advantage of that irrational behavior. —John Carder

A relative strength strategy, which is an enlightened form of trend-following, is simply profiting from the "madness of crowds."

High RS Asset Class:

High RS stocks, as an asset class, often move independently of broad indexes. Recent performance through 9/17/07:



"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 9/17/07

Sector Performance

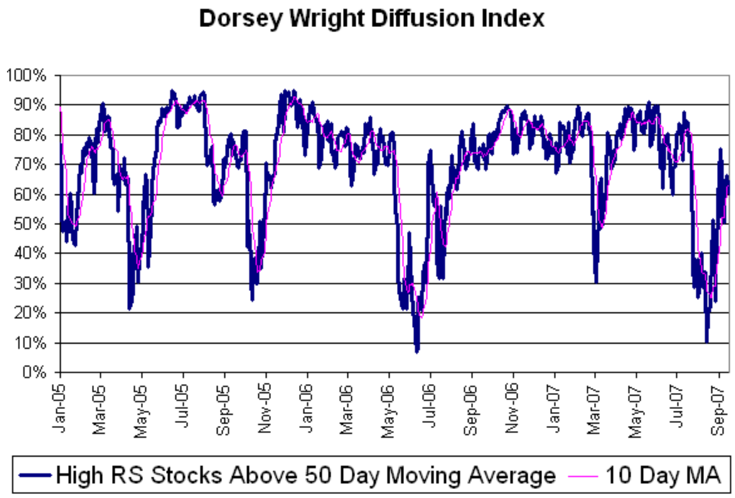
S&P 500 GICS Sector	12 Month	6 Month	1 Month
Energy	41.01%	28.99%	7.76%
Materials	26.33%	6.42%	6.59%
Telecommunications	20.37%	8.12%	2.14%
Industrials	18.91%	11.81%	3.10%
Technology	18.42%	13.06%	3.67%
Utilities	16.67%	2.83%	1.89%
Consumer Staples	6.67%	5.49%	1.33%
Consumer Discretionary	5.72%	-2.61%	1.99%
Health Care	4.28%	4.46%	2.06%
Financials	-2.32%	-4.40%	-2.68%

Performance by Capitalization

S&P Mid-Cap	13.97%	4.26%	2.23%
S&P Large-Cap	12.23%	6.91%	2.34%
S&P Small-Cap	9.68%	2.60%	-0.50%

High RS Diffusion Index

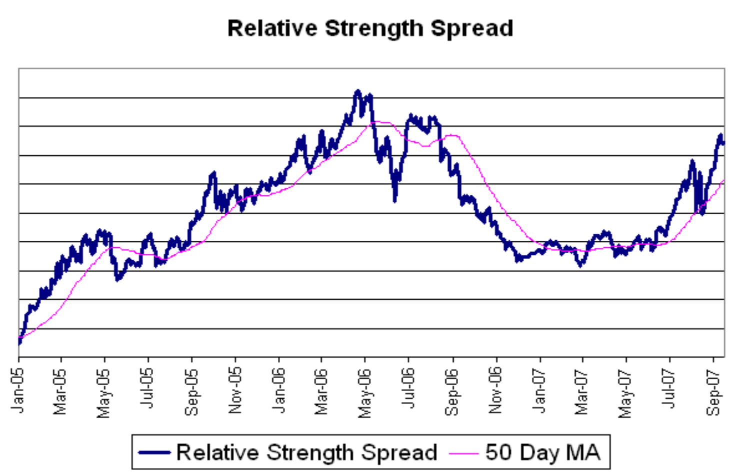
As of 9/17/07



Seeing how strongly high relative strength stocks have snapped back after the recent correction may cause some to ask the question, "Am I too late to add money to relative strength strategies?" We don't think so. Note how high RS stocks tend to spike sharply off the bottom, but can stay above their 50 day moving average 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 9/17/07



The current environment is very favorable for relative strength strategies as RS leaders are outperforming RS laggards.

Exposing Weak-Form EMH

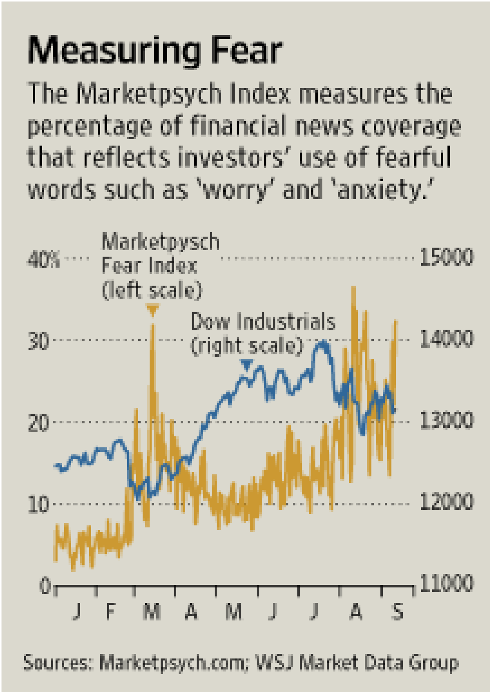
The efficient market hypothesis emerged as a prominent theory in the mid-1960's and continues to be taught with fervor in today's financial textbooks. The weak-form efficiency states that no excess returns can be earned by using investment strategies based on historical share prices or other financial data. Since relative strength strategies use nothing but historical price data, they would by quickly dismissed by those who accept the theory at face value.

The problem with the EMH is that it has been proven to be false. Consider the study completed by Narasimhan Jegadeesh and Sheridan Titman published in 1993, titled *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency.* The entire study can be found here. Their paper documents that strategies which buy stocks that have performed well in the past and sell stocks that have performed poorly in the past generate significant positive returns over the 1965-1989 period. For example, the strategy that they studied in the most detail selected stocks based on their past 6-month returns and held them for 6 months; the strategy realized a compound excess return of 12.01% per year on average. That simply should not be possible if the EMH is true.

Further debunking the EMH theory is the study on relative strength that the Dorsey Wright Money Management team published in 2005, which can be found here. As we note in our paper, much of the quantification of relative strength has not been directly applicable to portfolio management. Usually, the stocks get divided into segments (tiling) and the results of the various segments are broken out. Often, these segments are the most extreme examples of relative strength and have commensurate volatility, or the segments are of such size that it would be difficult to construct a portfolio with so many stocks. In our paper, we show that simple relative strength strategies can be implemented with portfolios of as few as 20-25 stocks and with below industry average portfolio turnover, resulting in significant excess return over time.

Those looking to further convince themselves of the falseness of the EMH claims, can find a number of valuable studies on our website, here.

Utility of Financial News



More reason to read the sports pages! This was included in the September 11, 2007 issue of *The Wall Street Journal*.

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)

- New ETF follows trends based on technical factors, *MarketWatch*, Mar 2, 2007
  http://tinyurl.com/2qt6cd

Arrow DWA Balanced Fund (DWAFX)

- Arrow DWA Balanced Fund Hits $100 Million in Assets, *Marketwire,* September 11, 2007
  http://tinyurl.com/336e6u

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- 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

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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