Dorsey Wright & Associates Money Management

Manager Insights
Systematic RS Portfolios

December 31, 2009

Fourth Quarter Review

World markets experienced a wild ride during 2009. The year began with more of the same from 2008—very weak equity markets, and U.S. Government Bonds holding up well. That theme abruptly ended in the middle of March, and we saw a dramatic leadership change. Our portfolios' performance followed that same pattern. During the first two months of the year (the extension of the previous year's trend), the portfolios performed well on a relative basis. As the market changed character, our strategies lagged. The amount of underperformance was the highest right around the market reversal, and the gap narrowed as the year progressed.

The laggard rally that began at the market low in March was one for the record books. Any time the laggards outperform the leaders it is difficult for relative strength strategies to perform well. What typically performs well in these environments are value-based strategies. Using data from Ken French's Data Library we were able to take a look at some of the larger laggard rallies in history. The table below shows all of the periods where the laggards outperformed the leaders by 20% or more. (The data is monthly)

Date Of Market Low	Laggard Outperformance
May 1932	186.25%
February 2009	77.23%
March 1938	37.27%
September 2002	36.44%
September 1990	28.06%
April 1970	26.44%

This current laggard rally was the second largest in history! It is rather amazing to note it has been twice as large as the rally off the bear market low in 2002.

Drilling into the constituents of the S&P 500 index also shows the effect of the laggard rally on stock returns this year. The following chart was taken from Bespoke Investment Group and breaks the stocks of the S&P 500 into 10 groups based on each stock's return in 2008. Then the returns from 2009 are measured in relation to each group's trailing return.

It is clear that the stocks that led the bear market lower turned out to be the best performers last year.

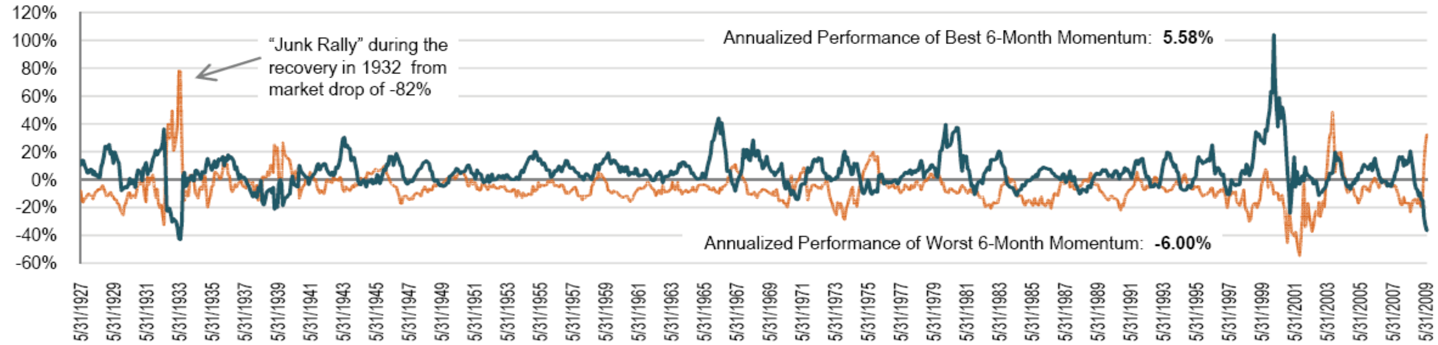
On a global and asset class basis, the laggard rally was evident too. Areas such as Emerging Markets had eye popping returns in 2009 after posting dismal performance the year before. U.S. Government Bonds soared during the flight to quality in 2008, but delivered poor returns this year. In the credit markets, High Yield securities had a spectacular rebound this year. The one major theme that ran through most every market this year was investors' renewed appetite for risk.

As more time has passed from the market low in March, we have started to see more and more signs of improvement in the High RS market. While we are certainly not in the type of environment yet where RS really excels, we have several reasons to think that time will come sooner rather than later.

Going back to the 1920's, RS has proven to be an extremely resilient investment factor. It outperforms more often than it underperforms, and

Figure 5: Rolling 12-Month Excess Returns (January 1926 – June 2009)*

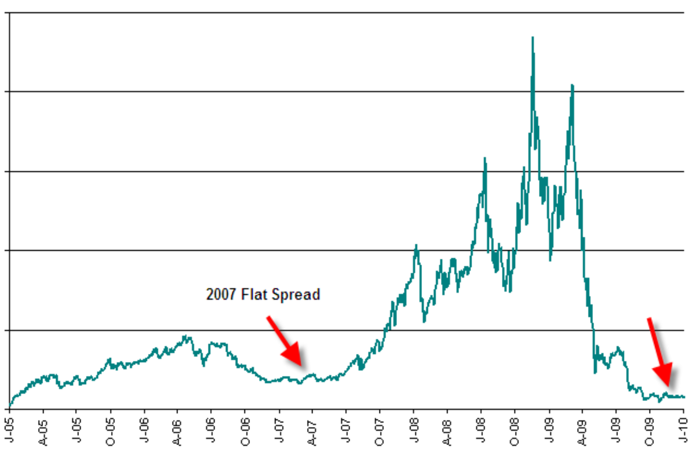
Portfolio based on Best and Worst 10% of 6-Month Price Momentum (6-Month Holding Period)



* Performance of the backtested composite rebalanced every six months. Excess return is relative to All Stocks Universe. The universe of All Stocks consists of all securities in the CRSP Database with inflation-adjusted market capitalization greater than $200 million as of 12/31/08. The stocks are equally weighted and generally rebalanced every six months Excess return is shown on rolling 12-month periods.

when it does underperform, the leaders generally snap back with good performance. That is the adaptive nature of the process. The chart above was taken from a presentation by O'Shaughnessy Asset Management and looks at leader vs. laggard performance on a trailing 12 month basis. Back in 1932, the last time we saw this magnitude of laggard rally, the leaders snapped back very sharply and continued to outperform for quite some time.

On a near-term basis, we have noticed a flattening out in our RS spread. In order to construct this indicator, we simply compare the performance of the top quartile of RS ranks versus the bottom quartile. When the spread is rising, the top quartile is outperforming the bottom. A rising spread is a good environment for our strategies.



You can see from the spread that the latest laggard rally wiped out all of the RS gains since 2005. The last time we saw big underperformance by the High RS stocks was in 2006. After that period, the spread flattened out and moved sideways before beginning to trend higher. It appears we have now entered that period after the latest laggard rally. We can't predict when an upturn will come, or how sharply it will move to the upside, but it is positive to see things stabilize like they did in 2006-2007.

Another area where we see promise is in the shape of the yield curve. The yield curve simply measures how short-term interest rates differ from long-term rates. Right now the yield curve is very steep. In fact, it hasn't been this steep since 1982! We believe that is very significant. There is an army of economic forecasters, but the shape of the yield curve has proven to be more reliable than their forecasts over time. When the yield curve is steep it forecasts increased economic activity, and when it is inverted (meaning short-term rates are actually higher than long-term rates) it forecasts decreased activity. While the media seems to be focusing on all of our immediate economic problems, the market is expecting a more robust and inflationary environment down the road.

Time is also on our side. The farther we get from the bear market bottom, the better things look for RS strategies. As time passes, investors begin to separate the winners from the losers. At the beginning of the rally investors were simply relieved, but as we move along we are seeing signs that good stocks are being rewarded. This is the same process we saw play out off the bottom in 2002, although to a much lesser degree.

The past year was difficult for relative strength, but we are seeing signs of the tide beginning to turn. Looking back through history shows the factor we use has always delivered periods of out performance after periods of underperformance. *We believe that as you evaluate your overall portfolio for the coming year, now is a fantastic time to increase your exposure to relative strength based strategies.*