Point and Figure Basics

Technical Insights, Powerful Solutions

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Simply stated, Dorsey Wright focuses on price movements of securities, which are the ultimate determinant of supply and demand in the marketplace. When you cut through all the red tape on Wall Street, what moves stock (and thus ETF) prices is supply and demand. It is nothing more than ECONOMICS 101. We know why tomatoes in the winter don’t taste very good, don’t have a very long shelf life, and are expensive. The same forces that move prices in the supermarket move the stock market. When it’s all said and done, if there are more buyers than sellers willing to sell, the price will move higher. If there are more sellers than buyers willing to buy, the price will move lower. Therefore, analyzing the price action of a security over time can yield important information as to who is winning the battle for that security — supply or demand.

The Point & Figure methodology has been around for over 100 years. One of the first proponents of the methodology was Charles Dow, the first editor of the Wall Street Journal. Charles Dow was a fundamentalist at heart, yet he understood the importance of the supply and demand relationship in any stock.

Our Research Methodology: Simple Economics

A ROAD MAP FOR INVESTING
If you were going to take a trip, driving from Washington, DC to San Francisco, California, what would be the first thing you would do? Most likely, you would pull out your atlas or road map. You wouldn’t just blindly jump on any road and hope that it is the one that takes you to San Francisco. The probabilities of reaching your destination would be pretty slim. Unfortunately, most investors jump into an investment with no road map to guide them through their financial journey. The Point & Figure methodology provides us with an unbiased road map for the investment journey in any particular stock or ETF.

P&F CHART TENETS
The Point & Figure chart is simply a logical, sensible, organized way of recording supply and demand in any stock. It answers the question of WHEN to buy and sell.

X = Demand; rising column  O = Supply; declining column

Charts are plotted daily with the high and low, and each column must have at least 3 X’s or 3 O’s, and the columns alternate.

Time Reference: 1 = Jan, 2 = Feb, etc. A = Oct, B = Nov, C = Dec
Years are denoted at the bottom of the chart.
Blue Line is the Bearish Resistance Line. As long as a stock is below this line, the trend is considered negative.

Red Line is the Bullish Support Line. As long as a stock is above this line, the trend is considered positive.

A rising series of X’s and O’s (as seen in the chart on the left) tells us that demand is getting stronger and supply is getting weaker — that is what we want to see in stocks, ETFs and funds we own.

Patterns

In the Point & Figure methodology there are 11 different, identifiable patterns in the chart. They are all just variations on two basic patterns. Those two patterns are the Double Top and Double Bottom.

Double Top (Buy Signal): Column of X’s exceeds a previous column of X’s. The most basic buy signal or breakout.

Double Bottom (Sell Signal): Column of O’s exceeds a previous column of O’s. The most basic sell signal or breakdown.
Relative Strength vs Market

One of the most important tools in the Point & Figure method is relative strength. This unique tool measures the likelihood that a stock will outperform the base index, the S&P 500 Equal Weighted Index (SPXEWI). The calculation is quite simple:

\[
\text{RS Reading} = \left( \frac{\text{Stock Price}}{\text{SPXEWI}} \right) \times 100
\]

This relative strength reading is then plotted on a Point & Figure chart. Every stock has not only a traditional price (trend) chart but also a relative strength chart where we look at the signal (long term RS performance) and the most recent column (short term RS performance). The best RS reading is when the chart is on a buy signal and in a column of X’s.

Relative Strength vs Peers

In addition to measuring how a stock is likely to perform versus the market, we also measure each stock relative to a group of its peers. The goal of this relative strength chart is to pinpoint the “best in class.” The calculation is straightforward:

\[
\text{Peer RS Reading} = \left( \frac{\text{Stk Px}}{\text{DWA Sector Index}} \right) \times 100
\]

This relative strength reading is then plotted on a Point & Figure Chart. This chart is read similarly to the market relative strength chart. The signal, double top or double bottom, indicates likely longer term performance while the column is an indication of near term performance versus others in the sector.

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How Does Your Stock Rank?

For each stock, we can get a composite picture of the overall trend, relative strength versus the market, and relative strength versus the peer group with a Technical Attribute rank or score. There are five Technical Attributes which are evaluated:

- Trend
- Relative Strength vs the Market Signal
- Relative Strength vs the Market Column
- Relative Strength vs the Peer Group Signal
- Relative Strength vs the Peer Group Column

When evaluating a stock, if three of these attributes are positive (ideally with one of those being positive trend), we consider that stock a solid citizen and worthy of being considered for the portfolio. If one consistently keeps the portfolio invested in stocks (or funds) with at least three positive technical attributes, you have stacked the odds in your favor.

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Eastman Chemical Company (EMN)

Updated through - 06/16/2011 (95.250 Down 1.450) - View History
Chemicals Favored (Status: Bear Confirmed 42% Os on 05/12/2011 Wkd Mom: Neg (7Wks)
Mkt RS = Buy, 10/25/2010; col=Xs –Peer Rs = Sell, 12/28/1998; Col = Xs
Trend Chart Broke a Spread Triple Bottom on 06/16/2011 - Tech. Attrib. 4

At the top of a chart, the Technical Attributes are listed. A green arrow up means the attributes are moving higher; while a red arrow down means the attributes are moving lower. Strong stocks will move between 3 and 5 attributes. Weak stocks have a reading between 0 and 2 attributes.
How Does Your Fund Rank?

Mutual Fund and ETF Fund Score
The Dorsey, Wright Fund Score is a rating system that ranges from 0 to 6 and is similar in scope to the Technical Attribute ranking system we apply to stocks. The Fund Score expands the scope of analysis to other parameters including Chart Patterns, Moving Averages, Momentum and Percentile Ranking for the fund versus several Market and Peer Groups over several time periods. The Dorsey Wright Fund Score reflects a two thirds weighting toward relative strength measures and a one third weighting toward absolute price measurements. In general, when deciding on positions to include in a portfolio, a score of 3 or higher is acceptable, and ideally above 4.00.

Example: as shown to the right, the Rydex S&P EW Healthcare ETF (RYH) has an acceptable Fund Score of 4.71, above the important 3.00 threshold. Generally speaking, a high fund score will translate into a security that possesses positive trend and RS characteristics.

At the top of a chart, the Fund Score is displayed. Strong Funds will reside in the 4.00 to 6.00 range, while weak Funds are between 0 and 2.99. By focusing your buying on those ETFs and Mutual Funds with a high Fund Score, you further stack the odds in your favor.
Relative Strength Analysis: Asset Classes

Dynamic Asset Level Investing (D.A.L.I.) Report
The purpose of our Dynamic Asset Level Investing (DALI) Report is to provide you with a streamlined dynamic snapshot of the financial landscape. Specifically, it aids you in investing your portfolio across all types of assets in various market environments by using relative strength to guide allocation. We use an RS-based matrix to determine which assets should be emphasized or overweighted, allowing you to tactically adapt and change as the market conditions change.

Sample View of DALI from DWA Website
The Dynamic Asset Level Investing (DALI) evaluates six broad asset classes using an RS matrix comprised of a diversified universe that represents each asset class. We conduct an extensive RS wrestling match among all the representative securities, summarize the results on a daily basis, and then rank the asset classes from strongest to weakest based on their relative strength score or tally reading. For example, in the sample view above, Domestic Equities, Commodities and International Equities hold the top three spots. As a general rule, portfolios should be overweighted in the asset classes that hold the top spots, and underweighted in those asset classes with the lowest tally reading.

Sample View of DALI from DWA Website
DALI also provides guidance within each asset class and offers further functionality for effective portfolio management. Relative strength analysis can pinpoint areas of strength within an asset class, such as International Equities, shown to the right.

Ultimately, DALI’s purpose is to help provide a tactical overlay and guidance for allocation decisions among asset classes, as well as within asset classes, steering you toward those areas of the market that are in a condition of outperformance.
Numerous academic studies have shown that successful sector rotation is one of the most important determinants of portfolio success. Sectors rotate in and out of season just like produce in the supermarket. Sometimes those trends last for years, other times for months. The key to successful investing is to capture the explosive, positive outliers on the bell curve of sector returns and avoid the negative outliers. There are two main tools we use at DWA that guide our sector rotation strategy — Bullish Percents, an absolute measure, and Favored Status, a combination of trend and relative strength measurements.

**Sector Bullish Percents**

The same bullish percent concept is used to evaluate the broad markets is applied to sectors. Dorsey, Wright & Associates follows 40 different proprietary sectors in addition to the broad (and sub) economic sectors. The percent of stocks on a Point & Figure buy signal for each sector is plotted on a grid from 0% to 100%. This is a measure of absolute price performance (participation) by the group.

- 70% and above is the Red Zone or higher risk area for new purchases in the sector
- 30% and below is the Green Zone or lower risk area for new purchases in the sector.
- X’s = Sector is on Offense
- O’s = Sector is on Defense
- Optimum point for new positions is when Sector BP is in X’s and at/below 50%

**Favored Sector Status**

Favored Sector Status relies heavily on the concept of relative strength. How is the sector likely to perform within the context of the overall market? Those sectors exhibiting positive relative strength characteristics have the highest probabilities of outperforming the market averages. The Favored Sector Status is a measure of the potential magnitude a sector has to move.

**Favored Sector Determinants**

- Strength of near-term relative strength (Mkt RS chart column in Xs) for stocks in the group
- Strength of long-term relative strength (Mkt RS chart on a buy signal) for stocks in the group
- Percent of stocks in the sector trading above their bullish support lines (in a positive trend)
- Relative Strength column of the DWA Sector Index for the group

**Sector Status**

Favored Sector: 3 or 4 of above positive
Average Sector: 2 of the above positive
Unfavored Sector: 0 or 1 of above positive

**Sector Analysis**

When determining which sectors on which to focus, those with a Favored status and good field position on their bullish percent charts (around 50% or lower in X’s) will stack the odds in your favor. Favored sectors should make up the core of your holdings. Favored sectors must fall to Unfavored to be eliminated entirely from the portfolio. Treat Unfavored sectors whose bullish percent is in X’s as trading or shorter term plays in the portfolio, or groups to underweight.