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Diversified Momentum Rooted in Relative Strength

Achieving capital appreciation while preserving capital is a balancing task that is never easy to perform. Although it is not necessarily a predictor of future performance, technical analysis can help identify patterns that may in turn create profit opportunities. Joe Barrato, portfolio manager of the Arrow DWA Tactical Fund, employs proprietary models to find relative strength across equities, bonds and alternative assets for his diversified portfolio.

Joseph Barrato
CEO, Director of Investment Strategies

Joseph Barrato, CEO and Director of Investment Strategies, is a Founding Member of Arrow Investment Advisors, LLC, the adviser to Arrow Funds and ArrowShares. Since co-founding Arrow in 2006, he has overseen the firm's growth from a single fund provider to a boutique asset manager offering a unique lineup of tactical and alternative investment mutual funds and exchange traded funds (ETFs).

Joe's more than twenty years of financial industry experience entails six years at Rydex Investments where he served as director of product development and was positioned at the helm of the firm's research and educational initiatives for financial intermediaries. His accomplishments include developing portfolio research tools and sector momentum models which led to the creation of the first Rydex mutual fund intended for buy-and-hold investors.

Prior to Rydex, Joe spent 12 years at the Federal Reserve Board of Governors. As a financial analyst, he assisted economists and analyzed monetary aggregate data. As a senior financial examiner, he advised Fed officers and board officials on financial, operational and managerial enhancements. Joe holds a bachelor's degree in business administration from The George Washington University, where he majored in finance and minored in accounting.

What is the history of the fund and the company?

The Arrow DWA Tactical Fund was launched in 2008, and uses a tactical global macro strategy, technical analysis, and proprietary models focused on relative strength to achieve long-term capital appreciation as well as capital preservation.

Our company was founded ten years ago, when we partnered with the technical research firm Dorsey Wright & Associates (DWA) to launch this fund's precursor, the Balanced Fund. That fund was one of the first tactically managed funds to use a relative strength model, and had exposure to multiple asset classes through a balance of equities and bonds.

We wanted to evolve and create another product. Our initial thoughts focused on developing an investment strategy that could tilt anywhere without worrying about the balance between equities and bonds.

The Arrow DWA Tactical Fund allows us to execute this strategy using the technical analysis of Dorsey Wright. Many investment advisors rely on the firm's research to guide their buy and sell decisions, while we attempt to deliver a package solution.

Our strategy allows us to offer long and inverse exposures to global equities, global fixed income, and global alternative strategies. We use tools like exchange-traded funds (ETFs) to get that exposure, although at times we go into the equity baskets and build out exposure ourselves.

It is our wholehearted belief that tactical investing and alternative investments should be a core component of the portfolios of individual investors. This fund gives retail customers access to institutional-like strategies, and because it can put hedges on when market conditions change, is complementary to traditional investments that fall when the markets do.

Today, the fund's assets under management are about $238 million. As a firm, we have over $800 million under management among eight products, which include five mutual funds and three ETFs.

What is your investment philosophy and what role does technical analysis play in it?

We do not believe that technical analysis will predict the future, but rather that it allows us to identify and react to patterns in the marketplace.

The most important aspect of our philosophy is having a disciplined approach, and the tools needed to migrate through what is happening in the equity markets and global markets. This is the universe where we apply technical analysis with the help of models measuring against it in order to find investments with the greatest relative strength.

"The key difference is our fund uses diversified momentum and can pull from a variety of asset classes. The fund has the ability to rotate into and out of segments based on where strength appears."

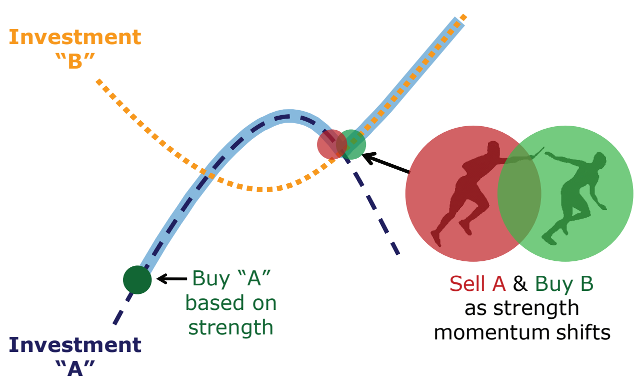
How does relative strength help in separating winners from losers?

By its most basic definition, relative strength is a measure of price and an indicator of how a security is performing relative to others. Indirectly, it shows the supply and demand for a specific instrument.

Historically, relative strength has been a simple way to segment the market, and it is gaining greater relevance today. Because of its popularity as a methodology, having so many strategies chasing the same things could potentially dry up alpha. As a result, we remain careful when building our universe to make sure it will capture returns effectively.

In our view, relative strength is a discipline that is always looking for winners among a universe of securities, and always trying to find ways to bring those winners into the portfolio. In many cases it helps our portfolio outperform the market, like we did during the 2008-2009 financial crisis.

Relative Strength "Passes the Baton"



Of course, relative strength models also experience periods of under-performance. In the years following the crash, we have seen an amazing bounce which has made outperformance hard for active managers and tactical managers. There has been no real dispersion in the marketplace, and relative strength models need that dispersion.

However, because investors typically do not have the behavior to hold an investment longer than two or three years, we believe a relative-strength strategy can be complementary and important to have in a blended portfolio.

Although no one can ever identify the perfect bottom or the perfect top, we believe using relative strength gives us the discipline to hold out through market gyrations, come into an asset class as it is rising, and get out of an instrument before it starts hitting bottom.

How does your investment process work?

We divide investments into three buckets including equities, fixed-income, and alternatives. Each bucket has underlying independent models of relative strength, and only the strongest components rotate into the portfolio.

Under the equity basket, we have models of global alpha, global dividend, global inverse, U.S. sector rotation, and U.S. style rotation; fixed income includes global income, global inflation, and U.S. Treasury rotation; and alternatives are commodity rotation, currency rotation, and global REITs.

Market Segment	Description	Min	Max
Equities	Provides long/short exposure to domestic, international and emerging market equities. Short (or inverse) exposure will generally not exceed an allocation of 30%	**0%**	**100%**
Fixed Income	Provides exposure to domestic, international and emerging fixed income markets, including corporate, government and agency bonds.	**0%**	**100%**
Alternatives	Includes global exposure to real estate, currencies and commodities. Allocations will generally not exceed 30% for each of these individual alternative strategies.	**0%**	**90%**

Portfolio allocations are based on initial investment amounts and may vary with market fluctuation.

REITs are currently 10% of the portfolio because the strength of global REITs has driven the sector to become a part of our investment strategy. The same happened with gold. It recently entered the portfolio, with different components coming in based on the gold futures model in the alternative basket's commodity rotation strategy.

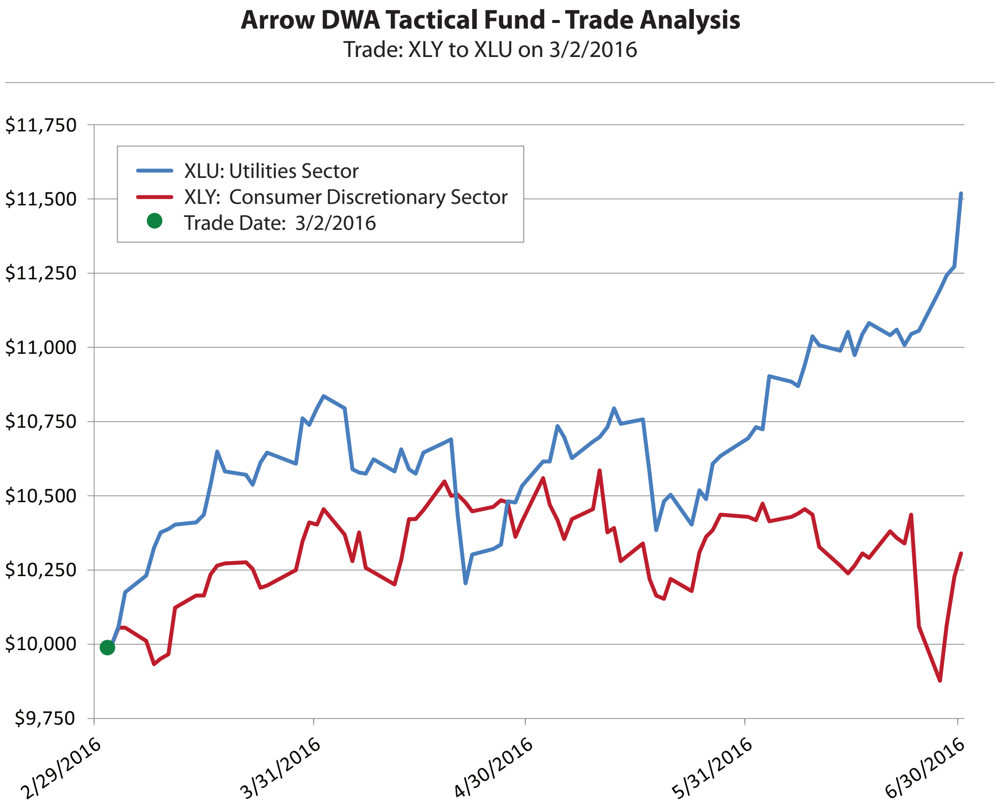
Because our relative strength model relies on the formula of the universe, establishing the foundation or baseline for the investment strategy is critical. As such, we have built out our underlying models from the ground floor, using different asset classes, ETFs, and indexes.

ETFs are especially crucial when building the baseline as they give us exposure to particular market segments and allow our global macro model to capture desired returns. Because of the importance of ETFs, we must ensure they are tracking the indices they are tied to, and determine whether each will provide the performance it was designed to deliver, even with fees.

Once the baseline and underlying models are built out, next we identify the universe of desirable asset classes and rank them on a timeframe—be it three months, six months, or a year.

Our methodology determines how these will be employed, and how frequently. Execution and implementation happen on a daily basis as we evaluate technical research around the overall universe, and obviously during times when things exit or come into the portfolio.

When replacing something in the portfolio, our model always seeks relative strength and outperformance. For example, the fund recently moved out of the consumer discretionary sector and into utilities. While consumer discretionary has risen about 3%, the sector we moved into is up significantly more, by 15.2%.



Past performance is not indicative of future returns. The information above is not intended as an offer to buy, sell, or promote and security. Source: Bloomberg/Arrow Investment Advisors, LLC.

How is the fund different from its peers?

Retail investors can get exposure to tactical investing in a number of ways, including mutual funds, ETFs, packaged solutions like mutual ETFs, or by doing it themselves and utilizing technical research to rank their own baskets.

What investors should be aware of and careful about with a sector rotation-only strategy in a mutual fund wrapper, or even an ETF wrapper, is it is still an equity strategy. When the equity markets correct, these strategies go down, although perhaps not as much.

The key difference is that our fund uses diversified momentum and can pull from a variety of asset classes. So, we are not wedded to just sectors, or domestic equities, or the alternatives basket. The fund has the ability to rotate into and out of segments based on where strength appears.

What is your portfolio construction process?

At any time, the fund can be in equities, alternatives, or fixed income. Right now, 70% of the portfolio is in equity-like ETFs, has about 9% exposure to fixed income, and approximately 21% exposure to alternatives, which are REITs and gold. The fund has a seven- to 10-year exposure in fixed-income securities.

The key is any of these baskets could go from zero to 100 based on its strength relative to the market. Within equities, the product has migrated toward quality stocks, like companies that consistently pay dividends. We believe we need to be more selective when buying companies because of the market run up that has happened over the last five years.

Arrow DWA Tactical Fund

Company	Arrow Investment Advisors Advisors
Symbol	DWTFX (Class A) DWTNX (Class I)
Address	6100 Chevy Chase Dr., Ste. 100 Laurel, MD 20707
Phone	877-277-6933
Website	www.arrowfunds.com

Source: Company Documents

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How do you define and manage risk?

By nature, a tactical investment approach protects against risk, but there is no defined approach to targeting risk.

The real risk controls inside our investment approach have to do with its universe, ranking among that universe, and having the ability to add alternatives to the portfolio.

Our basket approach lowers the fund's volatility, as does exposure to alternatives. Because alternatives act differently from traditional assets—they are up when traditional assets are down —exposure to them helps mitigate risk.

Standard deviation is a familiar means of determining how a fund measures against its peers or the market. This fund's risk profile is quite similar to that of the equity market; over the last year, the equity market's standard deviation has been approximately 14.47, and the fund's is 11.16.

As a group, the tactical category has lower volatility than the market, although this does not mean it is outperforming. The equity market has been strong, rising about 11% in the last three years.

The tactical category has not been as robust, offering an average return of about 2.7% in the same period. Our fund has an annual average return of 7%, and is holding against its peers, while doing so with less volatility than the market. T

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The Arrow DWA Tactical Fund may not be suitable for all investors. The fund may invest in commodity-related securities, which may be subject to greater volatility than investments in traditional securities. The fund may invest in international and emerging market securities, which may be subject to special risks including fluctuations in currency, government regulation, differences in accounting standards and liquidity. Investing in small-cap securities may have special risks, including wider variations in earning and business prospects than larger, more established companies. The fund may invest in real estate-related securities, which may be subject to mortgage-related risks and real estate market fluctuations, The fund may invest in fixed income securities, which are subject to risks including interest rate, credit and inflation. Portfolio holding are subject to change and should not be considered investment advice.

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