



More mania than market, author says

By Harriett Johnson-Brackey

The guy who taught a lot of investors how to find good stocks doesn't own any now. Michael O'Higgins is completely into Treasury bonds. He hasn't owned any stocks in almost every year of this amazing bull market.

It's not that he wouldn't go back to them. But the author of the widely known Dogs of the Dow theory says bonds are undervalued. Stocks, at today's over-the-top prices, aren't. "You're supposed to get paid to take a risk," he says. "But you're paying them."

A bear in bull territory

O'Higgins, who manages \$100 million for a small cadre of clients at his Miami Beach firm, O'Higgins Asset Management, has moved on from his 1990 top-selling *Beating the Dow*. In his latest book, *Beating the Dow with Bonds*, he details a system that tells investors when to enter or exit the stock market.

A BROAD GAP

All of O'Higgins' signs point to the exit door right now. Prices are so high, he says, it's a mania rather than a market.

The broad gap between winning shares and the much larger number of losers is reflective of big downturns in the past. "In general, markets overreact," he says.

Too much upside will be followed by such a strong downside that he expects an across-the-board drop of 40 to 50 percent.

O'Higgins knows what it's like to be in the path of a market mood swing. His *Beating the Dow* steered investors toward low-priced, high-dividend stocks. The Dogs of the Dow theory, based on selecting a handful of Dow Jones industrial average underperformers, became so widespread that O'Higgins estimates \$20 billion flowed into mutual funds and money managers who used it.

However, blue-chip Dogs haven't been the best bet in these boom times. The Dogs' portfolio only beat an S&P 500 index fund or the Dow average in one of the last five years.

BONDS VS. STOCKS

Michael O'Higgins' bond portfolios beat the Dow Jones Industrial Average three of five years.

Year	Strategy	Beat the Dow with Bonds Return	Dow Return
1995	30-year Zeros	63.80%	36.49%
1996	1-year T-Bills	5.49%	28.61%
1997	30-year Zeros	29.22%	24.74%
1998	30-year Zeros	23.83%	17.93%
1999	30-year Zeros	-22.04%	26.96%

Note: Zeros are zero coupon Treasury bonds, which pay no interest until maturity and which sell for steep discounts from their face value.

What's more, O'Higgins' new method – zig-zagging into and out of bonds, Treasury Bills and stocks – hasn't proved itself to be foolproof.

Once a year, he rejiggers his portfolio according to the new system. Last year, it steered him into long-term zero coupon Treasury bonds. He suffered a 22 percent drop. In 1996, a great year for stocks, he got only 5.5 percent because he moved into one-year T-bills. His best year was 1995, when he posted a 64 percent gain.

So far this year, things are good. By the middle of last week, he had a 13 percent return on his all-Treasury portfolio. The mutual fund he runs for small investors is posting a just-under 10 percent gain. Meanwhile, the Dow was down 12 percent and the S&P was down by 7 percent.

O'Higgins' new method aims to simply compare the risks and rewards of each type of investment. To make a direct comparison between stocks and bonds, for example, he turns the notion of price-to-earnings ratio upside down. If the stock is earning \$5 a share and selling for \$165, it has a PE of 33. He instead uses earnings yield, taking that \$5 and dividing it by the \$165 share price, to say the stock has an earnings yield of 3 percent.

Then, he compares the earning yield of the S&P 500 to the yield of top-rated corporate bonds. Since stocks are supposedly riskier than bonds, they should have greater rewards.

Today, however, the earnings yields on stocks are lower than bond yields.

That's the first step in his asset allocation system. Next, it's on to the not-small task of predicting the direction of the bond market. That he does by looking at the price of gold. When it's rising, investors are expecting inflation which causes havoc in the bond market.

By using last year's change in the price of gold, O'Higgins argues in his book that investors would have predicted the direction of the next year's bond market 28 out of 29 times.

There's more to it than that – such as considering the default risk of corporate bonds and the relative safety of Treasuries – but O'Higgins says it won't take anyone more than a half hour a year and a copy of Barron's to determine where to invest.

BETTING ON A FALL

Now, he's betting on falling long-term interest rates. When interest rates fall, bond prices rise and his portfolio becomes more valuable. O'Higgins notes that historically, 30-year Treasury bonds tend to yield two percentage points more than the underlying inflation rate. If that were the case today, the long bond would be paying around 4.6 percent. But it's not. Last week, it was around 6.15 percent.

Interest rates, in O'Higgins' opinion, will decline to come more in line with that two-percentage-point norm. He's holding long-term zeroes coupon Treasury bonds that yield 6.11 percent to maturity. If rates come down according to his expectations, new zeros would yield 5 percent. That would lift the price of his old ones, which have a 27-year maturity, about 40 percent.