
BETTING ON THE DOGS

By David McEwen

In times when the market is fully valued but there are not enough clouds on the horizon to justify a wholesale move into cash, investors can make profits by buying shares that might have been overlooked by the rest of the market, but which are sure to attract attention in the future.

These companies tend to be poorest performers among the largest capitalisation stocks (the biggest companies), such as those that make up an index such as the NZX50. Research has found that those that do the worst in any given year tend to be the best performers in the following year.

One of the reasons of this is that most institutional investors, such as pension funds and unit trusts, invest the bulk of their funds in major cap shares. If such funds favour a certain group of shares, their price eventually rises to where they are expensive relative to others in the index.

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Since major cap shares tend to be financially sound and well run, the funds sooner or later start putting money into the less expensive shares on the index. If a share is out of favour because its financial performance is poor, it is only a matter of time before that situation is rectified.

This can occur either by a restructuring or change in strategy by management, a replacement of management by others or by a change in ownership as a rival takes advantage of a relatively low price. In general, a company that underperforms others in its industry will eventually see some change to rectify that poor performance.

This concept was formalised in the early 1990s by US investment advisor Michael O'Higgins in 1991. His strategy is that each investor should buy the ten Dow Jones Industrial Average shares (of which there are 30) whose dividend yield is the highest. This strategy is based on the observation that blue chip companies rarely alter their dividend to reflect trading conditions and therefore the dividend is a measure of the average worth of the company.

The share price, in contrast, fluctuates through the business cycle. This should mean that companies with a high yield (a high dividend relative to price) are likely to see their price increase faster than low yield companies. As simple as this theory sounds, it has proven extremely successful.

One fan of the concept, investment advisor James O'Shaughnessy has researched the strategy back to 1929. He found that The Dogs of the Dow strategy would have produced a compound average return of 12.7% a year, while the overall market grew by 9.9%.

History has found that major cap shares with high dividends eventually appreciate in price until their return is in line with other blue chips.

The process is quite mechanical where you get hold of a list of NZX50 shares at the end of the year, and choose ten with the highest dividend yield. One variation is that you avoid the two highest yielding and choose those below. That's because the highest yielding share sometimes can be in permanent trouble (think Kodak in the age of digital cameras) and its price will not recover.

The strength of this system is that you are forced to avoid investing in highly priced market darlings that are bound to disappoint the market at one time or another, and see their prices slashed.