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Streetwise: Dow theory one way to build a solid portfolio

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By Lauren Rudd

Investing is not difficult. Anyone with a modicum of common sense should have no difficulty building a successful portfolio. Yes, it is that easy and no, you do not need professional advice or specialized computer software or expensive newsletters and whatever else is being touted these days by those claiming to have an "inside track."

At the same time, every investor dreams of finding Wall Street's Holy Grail, that flawless method for deciding which stocks to buy and when. For many it has become an obsession, while for others a hopeless crusade. Unfortunately, such a system does not exist.

Yet, there is one technique that anyone can use to build a decent portfolio -- in a period of about 20 minutes. Your total commission cost, if you use a discount brokerage house, should not exceed $45 and you do not have to look at your portfolio for a year.

Developed by money manager Michael O'Higgins, the methodology is referred to as the Dow 5 theory and it was originally described in his book "Beating the Dow" (Harper Collins Publishers, 1991). Mr. O'Higgins' strategy limits your selection of possible investment candidates to the 30 companies that make up the Dow Jones industrial average.

As Mr. O'Higgins points out, these companies are among the most widely held, widely analyzed and widely publicized companies in the world. They also are among the largest and strongest of the world's corporate giants. Combined, the 30 Dow companies have assets of more than a trillion dollars, more than 4.5 million employees, and sales that exceed the gross national product of every country in the world except the United States, the old Soviet Union and Japan.

These companies may gain, lose, spin off, acquire, merge, rename themselves, reorganize, or even drop out of the Dow, but they are an integral and vital part of our economic system. In one form or another, these companies are here to stay.

The Dow 5 theory consists of selecting from the Dow 30 the five lowest priced stocks out of the 10 with the highest dividend yield. You buy an equal dollar amount, not an equal number of shares, of each of these five companies and hold the shares for one year. On the anniversary of your purchase, you again identify the five lowest priced stocks out of the 10 with the highest yield and adjust your portfolio accordingly.

Does the Dow 5 theory work every year? No, there were some years, such as in 2005, when you will have an overall negative return. Here are some annual results:

For the year 2004, the total return for the Dow 5 was 12.4 percent. The S&P 500 had a total return of 10.9 percent, Fidelity Magellan (Ticker: FMAGX), 7.5 percent, and the Vanguard

Index 500, (VFINX) 10.7 percent. Remember that total return includes all dividends.

For 2005, the return on the Dow 5 was a -0.4 percent. As I said, things do not work out perfectly every year. For the same period, the S&P had a total return of 4.9 percent, Fidelity Magellan 6.4 percent and the Vanguard Index 4.8 percent.

However, look at last year's results. For 2006, the return on the Dow 5 was a 42 percent, while the S&P had a total return of 15.8 percent, Fidelity Magellan, 7.2 percent, and the Vanguard Index 15.6 percent.

Want some long-term numbers? Remembering that I have continually made the point that an investment horizon is 3 to 5 years, the 5-year average annual total annual return on the Dow 5 was 13.3 percent, while the S&P chalked up 7.6 percent return, Magellan, 4.5 percent, and the Vanguard Index, 7.5 percent.

For those who think that the last five years were fraught with abnormalities, during the past 15 years the average annual return on the Dow 5 was 15.9 percent, while the S&P returned 12 percent, the Magellan, 10.9 percent, and the Vanguard Index, 11.9 percent.

Please note that there is no ironclad rule that says your year has to start on Jan. 1. You can calculate a current Dow 5 list on any day. Remember, the purpose is to invest in some high-yielding blue chip stocks that currently are out of favor and hold those stocks for a minimum of one year.

(Lauren Rudd is a financial writer and columnist. You can write to him at LVERudd@aol.com or 5 Gulf Manor Drive, Venice, FL 34285. Telephone: 941-388-9570. Phone calls accepted from 9 a.m. to 3 p.m. For back columns see RuddReport.com.)

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