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Contrarians can win on just a morning's work

By Tom Stevenson

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The problem with active investment is it's a hard slog. Looking for new ideas and watching your portfolio to make sure the story hasn't changed can be a full-time job. What price a simple share selection method we could rely on to beat the market?

The good news is that, for extended periods, there has been one. Devised by American fund manager Michael O'Higgins, it has a track record of beating the averages by a wide margin and, better still, it is simplicity itself.

To follow O'Higgins' method takes no more than an hour of your time once a year, leaving you free to get on with your life.

The bad news is that O'Higgins' fantastic record has been getting patchier of late. While his method has had some good years over the past decade or so, it's no longer the sure fire winner it was up to about 1995, when people such as Jim Slater were writing books extolling its virtues and unit trust managers were launching funds to mimic the outperformance.

That said, the logic behind O'Higgins' stock-picking method remains compelling. For investors who want to do more than track the market but haven't the time or inclination to manage their investments more actively, O'Higgins is a sensible third way.

Michael O'Higgins honed his theory for Beating the Dow, an excellent book published in 1991 but updated since and still in print.

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Three assumptions underpin his approach. First, he argues that big companies are safer than smaller ones and so restricts his search to the 30 constituents of the Dow Jones Industrial Average.

Safety is important, he says, because the performance of the market is made up of hundreds of pluses and minuses. Stack the odds against a complete wipe-out by focusing on big stocks and you are already on the way to beating the market.

His second assumption is that markets over-react. Contrary to efficient market theory, investors rarely price shares correctly.

They are either too optimistic, as they were about tech stocks in the dotcom bubble, or too gloomy, as they were about pretty much everything in early 2003.

O'Higgins says the best way of identifying shares that are unfairly out of favour is to follow the yield. Shares with a high dividend payout relative to their share price are by definition relatively unpopular, often more so than they should be.

The third point on which O'Higgins' theory depends is that companies think hard before cutting their dividend because powerful investors hate it when companies disappoint their income expectations. As dividends are an important element in the total return from shares, it is logical to favour high income stocks.

O'Higgins investigated several methods of exploiting this big-stock, high-yield advantage. Most simply, he invested in the 10 highest yielders out of the 30 companies in the Dow.

In the 18-year period over which he tested the approach, these returned 16.6pc on average (dividends plus capital growth) compared with 10.4pc for the market as a whole.

By limiting himself further to the five lowest priced stocks from those 10 high yielders, he bumped up the return to 19.4pc. All his approaches involved holding the selected shares for a year before re-running the screen and adjusting the portfolio.

The O'Higgins Five		
	Price	Yield
DSG	154p	5.6%
Rentokil Initial	160p	4.8%
Severn Trent	1,030p	5.1%
Alliance & Leicester	902p	6.0%
Boots	607p	5.0%
Source: CD Refs, December 2005		

The simplest way of applying O'Higgins' approach to the UK market is to use the FTSE 100 as the base universe.

Using archived copies of its statistical service CD REFS, Charterhouse Communications' Chris Cole helped me back-test O'Higgins for the past three years.

Like O'Higgins, we searched for the 10 highest yielders from the FTSE 100. We then tweaked the approach slightly by replacing the five lowest-priced shares with the five smallest out of the top 10 yielders.

In the US, where share consolidations are rare, low price and small size are pretty much synonymous, but that's not the case here and size is what O'Higgins intended.

The results for the past three years have been surprisingly good. For the year to December 2003, the five shares selected rose by an average 13pc, more than twice as good as the FTSE 100's 6.2pc rise over the same period and, due to their initial yield of 6pc, they produced a total return of almost 20pc.

In the year to December 2004 the total return was 16pc, while the FTSE (with no dividends) rose 7.4pc. Over the past 12 months the O'Higgins method would have recorded a 27pc total return, well ahead of the market's 15.8pc rise even if you exclude the dividends. That's an impressive performance for a system that requires less than a morning's work a year.

Looking ahead, the latest issue of CD REFS (a snapshot at the end of November) flags the five companies in the table. It will come as no surprise, given the contrarian nature of the approach, that there are two retailers in the selection. And overall, the shares selected show why this is not an approach for those of a nervous disposition.

DSG's trading statement last month confirmed that the United Kingdom remains fiercely competitive. Like-for-like sales in the first half year to November were down at Currys, Dixons and PC World.

Boots also knows something about tough competition and trading is reported to be poor in the run-up to Christmas.

Gerry Robinson showed that there's value in Rentokil Initial but it remains well hidden. Results from Severn Trent showed how a generous price cap regime can result in healthy profits growth if costs are kept in check. But in this case it comes with an SFO investigation.

Finally, Alliance & Leicester offers a meaty 6pc yield but that is just as well given the flat-line share price performance over the past five years or so.

If the O'Higgins five do not inspire you with confidence, then that, I'm afraid, is the whole point.

Contrarian investing requires more courage than going with the flow and buying the flavour of the month.

And that is why an important part of the O'Higgins approach is the discipline to make your selection and then stick with all five of the shares for 12 months, come what may.

As the market's dogs are sometimes rescued by takeover, you have to be prepared to hang in there through periods of agonising doubt. Did I say that O'Higgins would make life easier?