
New Twist on Dow Dogs Guru's latest strategy throws Treasuries into mix

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The man who gave the world the Dogs of the Dow investment theory -- a widely used but sometimes faulty technique -- has devised another system that he claims will produce better returns.

Miami Beach money manager Michael B. O'Higgins, a staunch contrarian, says he expects to be greeted with ``howls of laughter and derision," because his new strategy requires investors to hold nothing but zero-coupon Treasury bonds this year.

Although novice investors

may believe that the stock market can only go up, O'Higgins points out that there have been many years when the combined price appreciation and interest from Treasury bills or bonds has exceeded the investment gains from stocks.

He expects that to happen this year.

He believes that stocks, which have vaulted a phenomenal 150 percent during the past four years, as measured by the Standard & Poor's 500 index, are on the brink of a terrible crash that will eradicate at least 50 percent of their current market values.

At present, the S&P 500 is selling at more than 30 times earnings for the latest 12 months and nearly seven times book value. Those valuations, O'Higgins notes, are more than twice the historical norms.

Inevitably, he says, stocks will ``regress to the mean."

O'Higgins has outlined his latest investment method in the new book ``Beating the Dow with Bonds" (HarperCollins, New York, \$24). The title harks back to his ``Beating the Dow" (1991), in which he spelled out his Dogs of the Dow theory.

With the new strategy, investors must decide once a year whether stocks, zero-coupon Treasury bonds or one-year Treasury bills offer the best value. They then invest 100 percent of their assets in whichever of those investments looks best and hold on for the next 12

months.

O'Higgins says that zero-coupon Treasury bonds look like the best investment now, even though they are yielding only a bit more than 5 percent annually -- near their historic lows.

He expects deflationary pressures to drive interest rates significantly lower, causing long-term bond prices to rise sharply. (Bond prices move in the opposite direction from interest rates.)

Zero-coupon bonds do not pay interest as other bonds do. They are priced at a large discount to their face value, and investors earn a profit by redeeming them at full face value when they mature.

The prices of zeros tend to fluctuate broadly, rising sharply when interest rates decline -- and vice versa. They can be bought through brokers, but not through the federal government. Zeros are more volatile and hence riskier than regular Treasuries.

Whatever the validity of his new theory, O'Higgins is correct in predicting that it will be greeted with skepticism.

It would be "a fairly risky bet" to shift all your money out of the stock market, warns money manager Craig Litman, with Litman/Gregory in Larkspur. "His basic premise boils down to market timing, which does not make sense for the typical investor."

Litman acknowledges that stocks are risky now. But he notes that the market has gone up year after year while market timers continually predicted impending doom. "The typical investor would be better served by deciding on a mix of assets, not by trying to guess market movements," he observes.

O'Higgins claims that his new strategy would have returned 23.8 percent annually from the start of 1972 through last September -- significantly better than his Dogs of the Dow theory, which would have returned 18.0 percent. The overall Dow gained 11.7 percent per year during the same period.

Despite its long-term success, the Dogs strategy has been a dog recently, failing to beat the overall Dow the past four years in a row.

"The strategy has become so popular that it no longer works as a contrarian strategy," O'Higgins explained in an interview. He estimates that investors worldwide have sunk \$20 billion into the Dow dogs.

With the Dogs strategy, you compare the dividend yields and market prices of all 30 Dow industrial stocks

once a year. You then buy the five lowest-price stocks among the 10 with the highest yields.

Using the new O'Higgins strategy, investors wouldn't have even bothered to buy stocks in 23 of the past 30 years. They would have held them only from the start of 1974 to the end of 1980.

The new strategy is more complicated than the old, but it is still simple -- or perhaps the word is simplistic -- requiring less than an hour of research per year.

First, you determine whether to put your money into stocks or Treasuries. If the choice is Treasuries, you then must decide whether to choose 30-year zero-coupon bonds or one-year bills.

O'Higgins provides worksheets in his book that let you make these decisions automatically, using data from the Market Week section of Barron's, the weekly investment newspaper. The data also is available on the Web site of O'Higgins' firm, O'Higgins Asset Management, at www.ohiggins.com.

The worksheets, which occupy only two pages out of 267, are the essential part of the book. Much of the rest is devoted to the logic behind the new strategy, and there also is a lot of padding -- for example, more than 60 pages devoted to profiles and price charts of all 30 Dow stocks.

The first step is to find what O'Higgins calls the "earnings yield" of the 380-stock Standard & Poor's industrial index. This is calculated by dividing 1 by the index's price-earnings ratio for the latest 12 months. Next, you find the yield to maturity of the most recently issued T-bond expiring 10 years from now. You then add 0.3 to that figure and compare the total with the S&P earnings yield.

If the earnings yield is higher, stocks are relatively undervalued, O'Higgins figures. He suggests that you load up on stocks, using the Dogs of the Dow method.

If the bond yield is higher -- as it is currently, by a substantial two-plus percentage points -- you would buy Treasuries.

To determine which type of Treasury, you compare the price of gold a year ago with the current price.

"The change in the price of gold has been a wonderful predictor of interest rates in the following year" O'Higgins explains. "It has predicted the course of interest rates in 28 of the past 29 years."

If the price of gold is higher than it was a year ago, that could signify an inflationary trend that could drive

interest rates higher, O'Higgins says.

In that case, he urges investors to put their money in one-year T-bills, so they can take advantage of possibly higher yields when the T-bills expire.

If the price of gold is lower than it was a year ago -- as is now the case -- there is supposedly no need to fear inflation, so you would buy the 30-year zero-coupon Treasuries.

O'Higgins has created a new no-load mutual fund, the O'Higgins Fund, which follows his new strategy and is fully invested in zero-coupon Treasuries. It has attracted \$3 million in assets so far.

DOGS OF THE DOW

While Michael O'Higgins considers this the wrong time to hold stocks, he says that when the time comes again, investors should use his Dogs of the Dow stock-picking method. Here's how it works:

-- Determine which 10 stocks among the 30 in the Dow Jones industrial average have the highest dividend yields. This is calculated by dividing the company's annual dividend per share by its price per share. It can be found in most newspaper stock listings.

O'Higgins believes that high dividend yields signify that companies have been unjustly neglected by investors, causing their prices to languish at artificially low levels.

-- Choose the five stocks out of the highest-yielding 10 that have the lowest prices.

A low price, like a high yield, signifies investor neglect, Higgins says.

-- Invest equal amounts of money in each of the five stocks, and hold them for a year. At the end of the year, analyze the Dow list again and draw up a revised selection of the five most-promising stocks.

Someone using the O'Higgins method as of the end of last week would have bought the following five Dow stocks:

-- Philip Morris, dividend yield: 3.8 percent; price: \$46.13

-- Caterpillar, dividend yield: 2.6 percent; price: \$46.25

-- Du Pont, dividend yield: 2.5 percent; price: \$55.13

-- Goodyear, dividend yield: 2.4 percent; price: \$51

-- Sears Roebuck, dividend yield: 2.3 percent; price: \$40.31

DECIDING WHETHER TO OWN STOCKS OR TREASURIES

In his new book, Michael O'Higgins provides a worksheet that helps you decide whether to invest in stocks or Treasuries in the next 12 months. If the choice is Treasuries, you also can use the worksheet to decide whether to buy 30-year zero-coupon bonds or one-year T-bills.

The data needed to complete the worksheet can be found in the Market Week section of Barron's, the weekly investment newspaper. It also is available on the Web site of O'Higgins Asset Management, at www.ohiggins.com

The figures shown below are as of the end of January.

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1. S&P earnings yield: 2.52%

Calculated by dividing 1 by the price-earnings ratio of the Standard & Poor's industrials, based on earnings for the latest 12 months.

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2. 10-year U.S. Government T-bond yield to maturity: 4.65%

10-year U.S. Government T-bond yield to maturity: the yield of the most recently issued T-bond expiring 10 years from now.

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3. Add 0.30% to 2: 4.95%

This gives you the estimated 10-year AAA-rated corporate bond yield, which you then compare with the S&P earnings yield.

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4. Subtract 1 from 3: 2.43%

If the number is positive, stocks are overvalued and you should buy Treasuries. Continue to Step 5 to

determine which type.

If the number is negative, stop here and buy stocks, using the five-stock Dogs of the Dow method.

5. The price of gold per ounce: \$285.40

Price last week, as reported by Handy and Harman.

6. The price of gold per ounce a year ago: \$304.88

7. Subtract number 6 from number 5: -\$19.48

This is the one-year change in the price of gold. If

the number is negative, invest in 30-year zero-coupon bonds.

If the number is positive, buy one-year T-bills.

Source: "Beating the Dow with Bonds"

HOW THE NEW STRATEGY WOULD HAVE WORKED

The chart shows the results that O'Higgins' new system for beating the Dow would have produced each year starting with 1972. It involves deciding once per year whether to invest in Treasury bonds, Treasury bills or stocks, then doing nothing for the next 12 months.

		Return from Dow Jones industrial stocks	Return from O'Higgins' strategy
1972	T-bills	18.2%	5.4%
'73	T-bills	-13.1%	6.8%
'74	Stocks	-23.1%	-3.8%
'75	Stocks	44.4%	70.1%
'76	Stocks	22.7%	40.8%
'77	Stocks	-12.7%	4.5%
'78	Stocks	2.7%	1.7%
'79	Stocks	10.5%	9.9%
'80	Stocks	21.4%	40.5%
'81	T-bills	-3.4%	13.3%
'82	Zeros	25.8%	156.1%
'83	T-bills	25.7%	10.0%
'84	Zeros	1.1%	20.4%
'85	Zeros	32.8%	106.9%
'86	T-bills	26.9%	5.9%
'87	T-bills	6.0%	5.2%
'88	T-bills	16.0%	9.0%
'89	Zeros	31.7%	45.3%
'90	Zeros	-.6%	0.3%
'91	Zeros	23.9%	35.8%
'92	Zeros	7.4%	7.8%
'93	Zeros	16.7%	39.5%
'94	T-bills	5.0%	7.2%

'95	Zeros	36.5%	85.1%
'96	T-bills	28.6%	5.5%
'97	Zeros	24.7%	29.2%
'98	Zeros	0.5%	24.4%
(Thru Sept.)			
Annual Average		11.66%	23.77%

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Investment strategies used: 1-year T-bills, O'Higgins Dow Five Stock Strategy, 30-year Zeros; figures have been rounded

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Source: ``Beating the Dow With Bonds,`` by Michael B. O'Higgins
Chronicle Graphic