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Editor's Notebook

Money manager values his theory

Kevin Gale

Michael B. O'Higgins' first book gained some measure of fame for his "Dogs of the Dow" theory, but the debut of his second book hasn't put readers on the gravy train, yet.

The formula in the book called for investing in long-term zero-coupon Treasury bonds at the beginning of 1999 and staying put. (Instead of offering ongoing interest payments, zero coupon bonds are sold at a discount to their face value at maturity.)

In early January last year, when interest rates were expected to drop, the call looked right. Instead, interest rates rose, which drove down the value of bonds with lower rates. The O'Higgins strategy resulted in a 22.04 percent drop in a year the Dow returned 26.96 percent, which may have left unfaithful readers muttering something about being on Ken-L Rations.

To be fair, his research shows that following his latest strategy since 1969 results in an annualized return of 21.97 percent compared with 13.05 percent for the Dow.

My calculations, based upon returns he provided, show $10,000 invested in 1969 following his strategy would have turned to $3.86 million by the end of 1999. A similar amount in the Dow would have grown to $397,462.

Despite last year's bad timing for the book debut, O'Higgins is evangelical when it comes to his record, which makes him stick out in a dot com world. I think it's refreshing to find someone who is still latched onto value investing like a dog with a, well, bone.

There's a lot at stake on the theory, whether it's the $100 million in discretionary assets O'Higgins manages or overvalued stocks in many investors portfolios that he says are ripe for a tumble.

Q. When did you first come up with investment theories?

A. I started in the early '70s. I was working for a firm called Spencer Trask & Co., which was reputed to be the best investment research firm in the country. In 1973 and 1974, following our analysts' recommendations, my clients lost over half their money. In the middle of that, I started doing my own research.

This was in the days before PCs. Some guys at a bank trust department in Ohio gave me the idea of focusing on the Dow components. Just focusing on those components was 25 percent of the market. I started doing research on how to beat the Dow and came up with this system [Dogs of the Dow, which involves investing in five of the worst-performing Dow stocks on the theory they will rebound.]

That was great until the early '80s, when interest rates on long-term Treasury bills went so high that bonds became cheaper than stocks. At that point, I started focusing more on the bond market.

Q. How does risk factor into investing?

A. You should only take risk when you are getting paid a lot of money to do it. Stocks are risky historically. You can't find too many people who say that now, but I'm one of them.

I compare the earnings yield, which is the P/E expressed as a percent, ie. let's use the current market multiple which is 33, equal to 3 percent [yield]. Historically the yield on common stocks has been substantially above the interest rates on triple corporate bonds. That's a fact.

The most extreme example was in 1950 when stocks sold at 6 times earnings, which is an earnings yield of almost 17 percent and AAA bonds paid 2.5 percent. Dividends were 7.5 percent in those days, so you have three times the bond rate in cash [a dividend] plus you have another 9.5 percent reinvested for you by the company.

Now the earnings yield is 3 percent compared to 6.5 percent on AAA corporates and dividends are 1.1 or 1.2 percent, so you are paying the market for the privilege of assuming the risk of owning common stocks.

It doesn't make sense. It doesn't compute. You get less than half the return, and earnings can go down. The yield on AAA bonds is guaranteed. The earnings yield on stocks is not guaranteed. The earnings on the Dow have declined roughly a third of a time this century.

Q. A lot of people are saying that the market is different this time. Are we in a new era?

A. We've had lots of new eras. Man creates and invests, finds different ways of doing things more efficiently. That's what makes progress. But we've had revolutionary progress before, such as inventing the telegraph, telephone, television, aircraft. They all have changed the way business is done -- not as rapidly as perhaps.

The issue is the prices of the S&P stocks and the tech stocks being too high.

[O'Higgins explains that the real rate of return on Treasuries, obtained by subtracting inflation, is 4 percent.] Historically that rate has been 2 percent going back thousands of years - the rate on high-quality bonds going back to Babylonian times. You are getting twice as much.

On the other hand, the average PE has been 15 times earnings. Let's put it this way: If stocks regress to median P/E ratios, it means they go down 55 percent. On the other hand, if long-term interest rates regress to median levels, my Treasury bonds go up by over 50 percent.

Q. What went wrong last year?

A. My indicators, which are not perfect, and the main indicator is the price of gold. The price of gold until this year had correctly predicted the ensuing year's direction in long-term interest rates 25 out of the last 30 years. Now it's down to 25 out of the last 31 years.

I would still put that prediction record against any economist, dead or alive. Secondly, on the five previous occasions when it got it wrong going back to 1968, it got it right the following year, which bodes well for the bond market for the next 12 months.

Q. What about the Fed?

A. Obviously the Fed has not done enough if you have this Internet mania in full force. They obviously have to do something to curb this speculation. The longer they wait, the more serious the damage.

Q. So you aren't buying into the theory that these stocks have stupendous earnings potential?

A. Look, there are very few that have earnings and they trade at ridiculous price-earnings ratios. I think one of the cheapest ones is AOL and it's at 327 times earnings and the stock is down from 95 to 73, so it's down by almost a third and it's 327 times. What's the inverse of that? 0.3 percent? Of course, Amazon has never made a dime.

[O'Higgins' comments came just days before the AOL, Time Warner merger announcement. On Tuesday, he said, "To turn around and take highly inflated stock and pay almost double what the market price for Time Warner was at the time was courageous to say the least."]

Q. OK, how about this analogy. We're in a gold rush and it's better to be Levi Strauss selling jeans than panning for gold?

A. Sure. What's the PE on Cisco? It's a relative bargain -- 120 times earnings. Great company, but selling 120 times earnings. Intel is 36 times earnings and I think their sales and earnings aren't going anywhere. It's amazing how many of these companies do not have a good earnings trend. Yet the PR machine keeps everybody investing -- a large number of investors have no idea what makes things tick.

Q. What does your formula indicate investors should do this year?

A. They should put all their money in long-term zero coupon bonds or the O'Higgins Fund, which is fully invested in zero coupon Treasuries. It's-a no load fund that had a great '98 (fifth-best performing fund in the third quarter when the market got killed), a terrible 1999. This year I think it will be up over 60 percent.

Q. So you see a big drop in rates?

A. Not even just to new lows just to back where we were in October, 4.71 percent. That would be a little over 2 percent above the current inflation rate by the way, which I expect to decline in the coming year. I think it will go somewhere between 4 and 4.6 percent. It should be a terrible year for stocks or a great year for bonds. Stocks in this century have generally advanced six years out of 10, declined four years out of 10. In every decade prior to the '90s the stock market declined in at least three years. In the `90s we have no years of decline. We just went through the ninth straight year of an up market. Furthermore, if you look back historically, the final year of a decade has historically been the worst year for the market, so we have a combination of very high levels of overvaluation, very high levels of speculation, a very tired and extended economic expansion and a cheap bond market that lead us to one conclusion: If you want to beat the Dow in 2000, buy bonds.

Q. There have a number of stories in the national media about value investors, who had a tough 1999, including Warren Buffett. Does it give you any comfort being in such illustrious company?

A. Oh sure. Value is the key to long-term performance. Value investing is historically the most reliable and prudent way to invest, and it's also more difficult because very often the companies behind value laden stocks are experiencing some problems, although that's not the case today. Many companies are cheap, because they are not in the limelight. Eventually value comes out one way or another. This, by the way, is the longest period in history in which value has underperformed so called growth.