



WALL STREET'S BEST MINDS

Why a 'Dogs of the World' Strategy Is a Winner

The man who popularized "Dogs of the Dow" recommends platinum and cheap foreign stocks.

By [MICHAEL B. O'HIGGINS](#)

May 20, 2014

Editor's Note: *O'Higgins is founder of O'Higgins Asset Management, a Miami-based firm. In his 1991 book, "Beating the Dow," O'Higgins popularized a strategy of picking the "Dogs of the Dow," the 10 stocks of the Dow Jones Industrial Average with the highest dividend yields, at the beginning of each year. [A version of this article with charts](#) is available.*

"In Times of Peace, Prepare for War." Those words were written by Vegetius, a writer of the Later Roman Empire, in 450 A.D. as part of a treatise about Roman warfare and military principles.

After listening to all of the bullish commentary emanating from the financial media recently, I'm feeling that it might be worth adopting as an appropriate strategy right now for those of us who think of ourselves as permanently involved in a "battle for investment survival."

After all, these certainly are "times of peace." Our economy continues to slowly recover from the Great Recession and Bear Market of 2008-2009. Our major stock market indices are making new all-time highs. Interest rates, both long and short term, sit near all-time low levels. Trophy art, real estate and collectibles fetch formerly unimaginable prices. The so-called Fear Index (VIX), currently below 13.00, is at a level consistent with a high degree of complacency and other indicators of investor sentiment such as the Investors Intelligence Bull/Bear Ratio (2.84) and institutional investor surveys are similarly sanguine.

Even our armed forces are relatively at peace, having withdrawn from Iraq and on the verge of doing so in Afghanistan.

The current 5-year-old bull market, when viewed from an historical perspective, is slightly above average in length and well above average in size. Whereas the current bull's length of 5.2 years is only 8 months longer than the median, the percentage increase in the S&P 500 is almost 80% higher than the median rise since 1932. There have been three other times during the same 81 year period when stocks advanced for longer periods and four other times when they rose by a larger percentage amount. This could very well be another one of those times.



How about valuation? Most prominent market observers, looking at forecasts for 2014 corporate earnings and applying them to current stock price levels, feel that U.S. stocks are, in general, either fairly valued or undervalued compared to historical price/earnings (P/E) ratios and, especially, versus interest rates currently available on 10 year U.S. Treasuries .

On the other hand, if one uses Robert Shiller's Cyclically Adjusted P/E history (CAPE), which is based on a 10 year average of inflation-adjusted earnings, our stock market looks quite overvalued at its current level of 26.4. From CAPE's point of view, the only other times when it was more overvalued than now were in 1929 just before the 86% stock market decline of 1929-32 and in 2000 immediately preceding the S&P's 49% drop in 2000-03.

While the view held by the overwhelming majority of investment "experts" is that both short and long term

interest rates are inevitably destined to rise, there are some well-regarded observers, such as Van Hoisington, Lacy Hunt, and Gary Schilling, who argue convincingly to the contrary. Furthermore, there have been long periods in the past, such as the 20 years from 1933 to 1955, when U.S. rates were kept artificially low by the U.S. Government for much longer than was warranted. In comparison, the 6 years of interest rate repression that we have experienced since 2008 seems rather short.

Another factor to consider is the outlook for inflation and its impact on real returns. Ever since U.S. Federal Reserve Chairman, Paul Volcker, decided to kill inflation in the early 1980s, consumer price inflation in the U.S., as measured by the Consumer Price Index (CPI), declined sharply and, in recent years, remained subdued in spite of our government's and central bank's efforts to the contrary. Although many people might consider low inflation to be a good thing, the U.S. Government is doing everything in its power to rekindle inflation in hopes of resuscitating the economy and inflating away our debt.

We should also consider the view of John Williams of ShadowStats.com who, using the methodology in place in the early 1980s, arrives at much higher inflation numbers than the U.S. Bureau of Labor Statistics (BLS), the agency responsible for calculating our CPI. As an example, according to Mr. Williams' calculations, U.S. inflation in 2013 was actually 9.08% instead of the 1.51% estimated by the BLS.

So, how is one to know which version of the above critical investment questions regarding equity valuations, interest rates and inflation to believe? And, assuming that one could pick the correct answer to each question, how would one know how to play it? The problem is that, even when one

manages to correctly predict the occurrence of a future event, it is very easy to pick the wrong investment vehicle or vehicles to play it profitably. An egregious example is the performance of physical gold versus the gold miners over the past 10 years during which the price of gold has more than tripled from \$400/oz to over \$1,300/oz while Newmont Mining, one of the world's largest gold miners has declined by 50%.

The Michael O'Higgins Absolute Return (MOAR) Strategy solves both problems. MOAR is a simple asset allocation method which has, historically, produced relatively high returns with very low volatility by spreading assets over four different asset classes: undervalued global stocks ("Dogs of the World"), physical gold or platinum, Intermediate Treasury Notes and Long Term Treasury Bonds, and rebalancing annually.

Generally, each sector is allocated 25% of the MOAR portfolio, except in years following a losing year for the equity portion of the strategy when an additional 15 percentage points, 5 percentage points taken from each of the other three portfolio sectors, are allocated to the equity portion giving it 40% of the total portfolio. For example, in 2009 and 2012, following the equity portion's loss of 47.59% in 2008 and 18.07% in 2011, its weighting was bumped up to 40% of the portfolio for the coming year. This overweighting of equities boosted MOAR's total return by 70% in 2009 and almost 24% in 2012.

The rationale for this tilting toward equities is that stocks, especially our "Dogs," tend not to decline for more than one year in a row. Increasing our equity exposure after such a loss allows us to capture a larger piece of the ensuing rebound. Should consecutive down years in equities occur, the weighting is further increased by 15 percentage point increments each year. That has only happened four times since 1928 (versus 13 one year declines) and not once since 1971.

Since 1971, the year when Nixon took us off the Gold Standard, the MOAR Strategy would have produced compound average annual returns of 12.94%, after a 1% management fee, versus 10.42% for the S&P 500, with only 4 mildly losing years ranging from -6.07% in 1981 to -0.52% in 1994 compared to the S&P's 9 losing years, some of which, such as 2008, were as large as -37.00%. Moreover, MOAR would have beaten stocks and inflation in the overwhelming majority of bull, bear and sideways markets for gold, equities and bonds that occurred during those 42 years.

Since 1928, the annual compound rates return comparisons are less striking, i.e. 9.56%/year (after a 1% management fee) for MOAR compared to 9.42% for the S&P. But the difference in MOAR's 16 mildly down years averaging -4.92% versus the S&P's 24 years of losses averaging -13.61% shows significantly less risk. Furthermore, over the past 85 years, if one had switched to the MOAR Strategy after each time the S&P had risen 5 years in a row (yearend 1928, 1951, 1986, 1995 and 2007), one would have handily beaten that index in 4 of the periods since then and done so with much less volatility and risk as well.

Unfortunately for us and for our clients, 2013 was one of those mildly losing years when using MOAR resulted in a loss of 4.58%, after fees, compared to the S&P 500's total return of 32.38%. For many investors, such a dismal relative return might cause them to abandon this time-tested strategy. But strongly believing in the validity of our strategy, we dutifully re-balanced our portfolios at

the end of 2013, taking money away from our Dogs of the World, which returned 17.08% last year, and adding to our losing positions in U.S. Treasuries and platinum.

MOAR's long term record gives plenty of support for doing just that. The fact that most investors do the opposite, i.e. try to do in the future what they should have done in the past, is what causes them to fail by wide margins to even come close to the long term returns that the market averages, or even the average mutual fund, have produced over time. The latest evidence of this phenomenon comes from a recent study by Morningstar which finds that investors managed to underperform the average mutual fund's return by an average of 2.5 percentage points annually during the past 10 years.

For 2014, the MOAR Strategy calls for investing as follows: 25% in Long Term U.S. Treasury Bonds (TLT), 25% in Intermediate Term Treasury Notes (IEF), 25% in platinum (PPLT) and 25% in the "Dogs of the World" (DOTW). This year's DOTW are: Belgium (EWK), Brazil (EWZ), Poland (EPOL), Russia (RSX) and Singapore (EWS).

So far this year, our MOAR Strategy has produced a total return of +5.69%, including income and net of fees, with only 25% of our money in stocks, versus total returns of +2.40% for the S&P 500 and +0.42% for the DJIA. Time will tell if the above allocation will prove profitable for the remainder of the year, but, after five consecutive years of stock market "peace," it might be a good time to prepare for "war" by diversifying into something like MOAR.

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