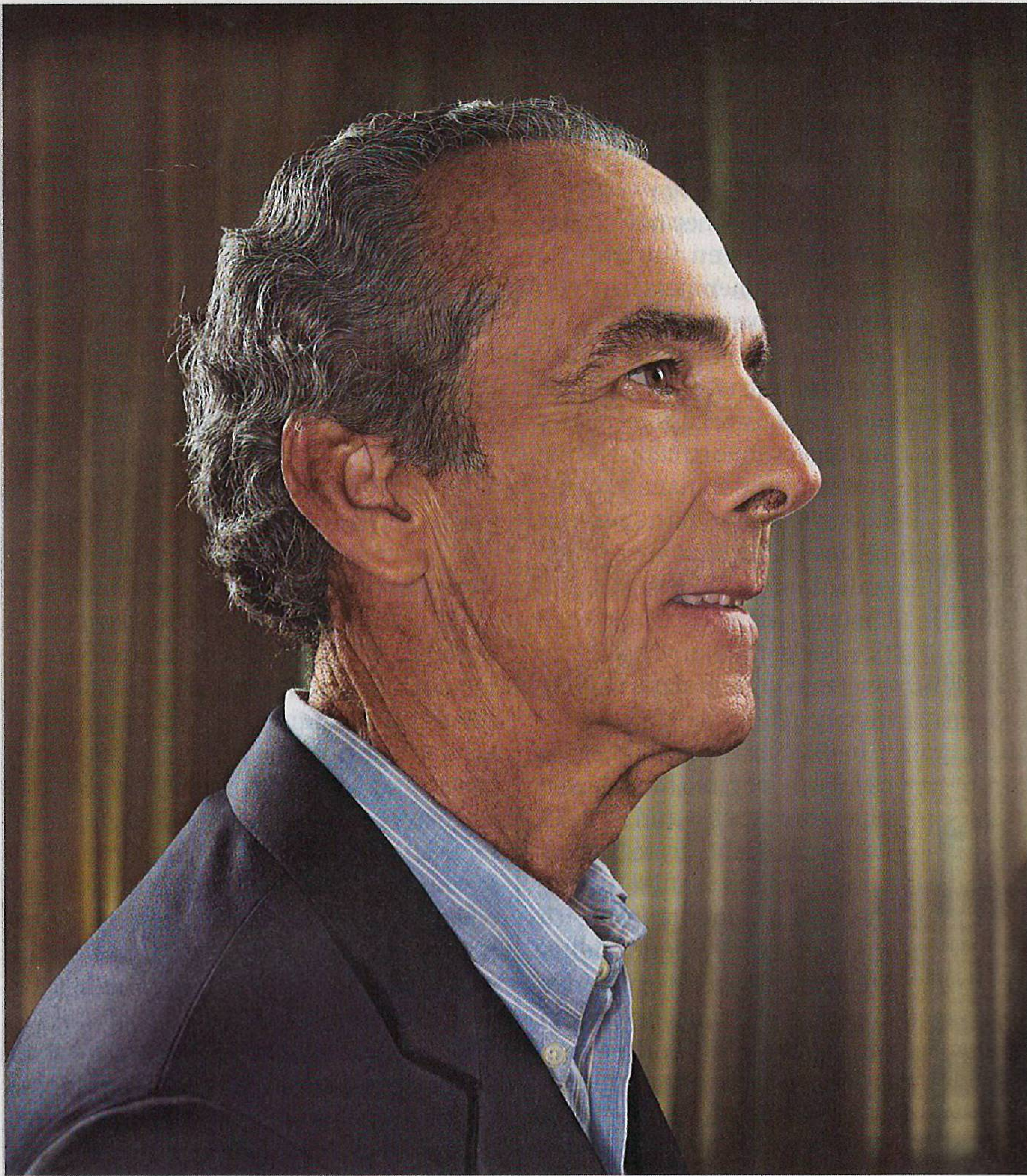


A WHOLE NEW WAY TO BEAT THE MARKET

Exclusive: The Dogs of the Dow creator launches a fresh twist **BY ANDREW HALLAM**

Many global investors today feel stuck having to choose the least of three evils. The United States is a heavily burdened lifeboat without a clear bailing system. Europe is a cracking tectonic fault line. And the Shanghai composite index is threatened by China's sluggish exports and weakening property market. In short, things look pretty bleak.

That's just how Michael O'Higgins likes it. Profiting from low market expectations is his specialty. Since forming O'Higgins Asset Management in 1978, the Venezuelan-born American has authored two successful investment books. His 1990 international bestseller, *Beating the Dow,* excited leagues of armchair investors with a simple investment method that anyone could follow. From 1973 to 2012, his strategy—based on Dow Jones Industrial Index stocks and dubbed Dogs of the Dow—would have gained seven times the S&P 500 returns.

In the 1998 follow-up, *Beating the Dow with Bonds,* O'Higgins boasted an even better performance for a method that alternated between stocks and bonds. When back-tested to 1973, the strategy averaged 17% annual returns. Its followers were unaffected by the 2000-2002 bear market, though they still felt the pain from the 2008 crash.

That financial meltdown prompted O'Higgins to find a more consistent strategy that could weather even the perfect market storm. Now, he is promising MOAR. That's the acronym for Michael O'Higgins Absolute Return, a diversified, indexed portfolio with a contrarian twist, designed for investors wanting both decent returns and a good night's sleep. When tested back 39 years, this latest refinement on O'Higgins's strategy would have averaged 14% returns with only three losing years, a 5% drop in 1981 being the worst.

O'Higgins has achieved outsized returns largely because he is the antithesis of the average investor. Most of us are influenced by our emotions and desire for immediate gratification. We chase popular stocks, hot asset classes or scorching funds, actions that tend to put us on the buy-high, sell-low treadmill of disappointment. According to *Barron's*, in the 20 years between 1988 and 2008, the typical American equity mutual fund averaged 8.4% per year, or 402% overall. The average investor, however, made just 1.9% per year, or 46% overall. Canadian results are likely similar.

Then there's O'Higgins. He buys established stocks nobody wants; he stockpiles foreign index funds that the rest of the world shuns; he loads up on bonds when stocks are most popular; and he earns returns that put most of our portfolios to shame. Like Warren Buffett, he uses logical methods, ignores his emotions and believes that nobody can consistently forecast the short-term direction of the economy or the markets—so he doesn't bother trying. Unlike Buffett, however, his strategies are easy to follow, if you have the right temperament.

UNDERSTANDABLY, YOU MIGHT BE WARY OF heeding the advice of a financial author, whether it's a back-tested scorecard promising high future returns or a plausible economic forecast paired with a game plan. And you'd be right to be cautious. Popular prognosticators can be dangerously wrong. So why listen to O'Higgins?

For starters, he isn't a market forecaster. In fact, he concluded years ago that analysts are terrible fortune tellers. In his second book, he related collecting 10 years of earnings projections by Wall Street analysts from the year-end issue of *BusinessWeek* magazine, and comparing those numbers to actual earnings. "The average margin of error, up or down, was 54%!"

14%
Annual return on O'Higgins's diversified, low-risk MOAR strategy since 1973

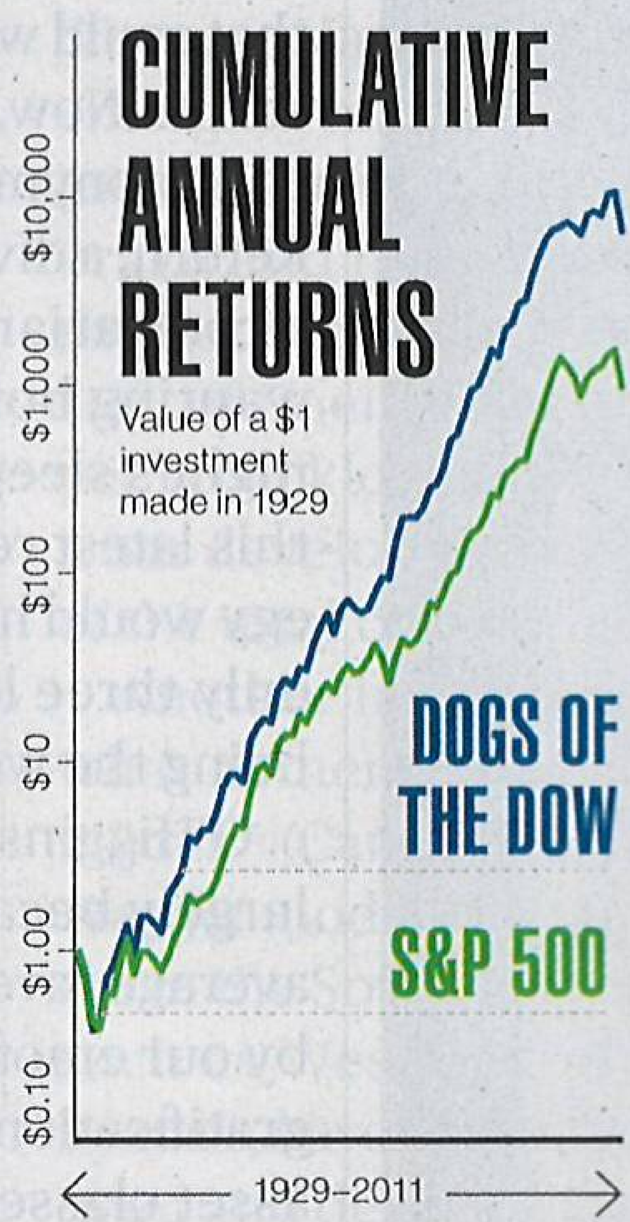
Photograph by Jeffery A. Salter

I caught up with O'Higgins in Singapore last month, while he and his wife were wrapping up their latest round-the-world trip, an annual treat. While he doesn't mind paying for quality (he was staying at one of the city's premier hotels), he remains a value hunter at the core. After we ordered our drinks, he scanned the menu and joked with the waiter about the excessively priced steak. His beef was serious, though: he suggested we find a more reasonably priced place to eat, which we proceeded to do.

At 65, O'Higgins is a fit man, thanks to regular swimming and tennis. These days, he lives in Miami Beach, but he grew up all over the world as his dad worked for a variety of oil companies. The family lived in Venezuela, the U.S., Singapore, Nigeria, Libya, Indonesia and Italy. His mother's Cuban family was once well-off: before the revolution, it owned the entire southern portion of the Veradero peninsula, now a popular getaway.

After earning a B.Sc. in economics, O'Higgins worked at a couple of investment firms before opening his own money management firm in 1978. What drove him out on his own was disillusionment. His employers directed client money into the most promising investments of the day, but the returns didn't live up to the hype. So he began hunting for a more reliable investment method. "When everyone is placing their bets on the hare, maybe the safer, surer bet is on the tortoise," he reasoned. And he wanted a strategy that was simple: "Something I would be able to do...without having to analyze thousands of companies."

His original plan involved buying the Dow stocks with the worst possible prospects. He figured that because of their pedigree, even the index's unpopular members had high statistical chances of eventually recovering. The companies had huge infrastructures, long histories, extensive customer bases and big revenue streams. "If the problem is poor management," he says, "new management comes in, sweeps away past policies, makes strategic changes that adjust to new realities, kicks the horse's flank to get it moving and starts making money again."



$9,451 AMOUNT YOU'D HAVE IF YOU INVESTED $1 IN THE DOGS IN 1929

$1,326 AMOUNT YOU'D HAVE IF YOU INVESTED $1 IN THE S&P 500 IN 1929

In 1978, he began placing his clients' money into five selected blue-chip stocks, and in 1990, he described the strategy in his book. It called for first finding the 10 Dow Jones stocks with the highest dividend yields. Steady or growing dividends are a sign of financial strength, plus if the dividend payout remains the same one year to the next but the stock price falls, the dividend yield increases. Seeking strong companies at cheap prices, O'Higgins used a high dividend yield as a guide.

Once you identify those top yielders, you buy the five lowest-priced stocks among them. After 12 months, determine whether your holdings still meet the original criteria. The stocks that don't meet the standard get sold and are replaced by the Dow's latest pariahs. (Based on this method, on April 12, 2012, you would have bought AT&T, Verizon, Merck, GE and Kraft.)

Companies that qualify as these Dogs of the Dow tend to be swamped with short-term problems, or their shares appear catatonic. So if you're looking for analysts to agree with your selections, you won't find many. And yet, since 1973, the Dogs had just five losing years, and averaged 14.8% annually over the past 39 years, compared to 9.7% for the S&P 500 (see chart below). Since 1929, a dollar invested in the S&P 500 would have grown to $1,326 by Oct. 31, 2011, versus $9,451 if invested in the Dow's dogs.

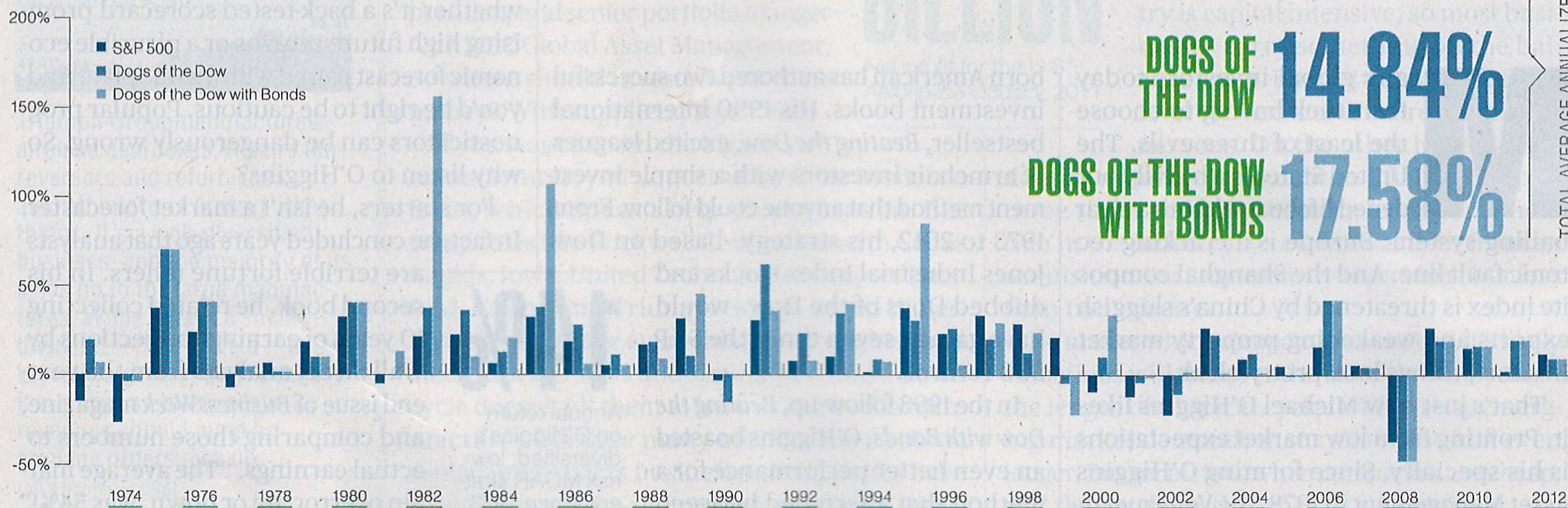
If you look more narrowly at the 10 years between the 1990 publication of *Beating the Dow* and the peak of the market run-up, however, O'Higgins's method trailed, gaining 17.1% per year compared to 18.6% for the S&P 500. Many O'Higgins supporters lost faith during that time and abandoned the strategy. We now know that this was history's best decade for stocks, a period characterized by what Alan Greenspan famously termed "irrational exuberance," when growth was rewarded regardless of price or value. Those who bailed on the strategy, according to O'Higgins, didn't give it enough time.

Most people are not very patient, he notes, giving up on their investment plans far too soon if they think they aren't working. From 1999 to April 16, 2012, believers were rewarded, with the Dow's dogs delivering a 69.8% cumulative gain, compared to 36.6% for the S&P 500. Overall, from 1973 to 2012, those unpopular Dow stocks flourished, gaining 14.8% annually, compared to 9.7% for the S&P 500.

By the late 1990s, however, O'Higgins grew uncomfortable with the high expec-

HOW THE UNDERDOGS BEAT THE MARKET

Below are the historical returns by year for the S&P 500, the Dogs, and the Dogs with Bonds



tations investors were placing on stocks. Worried about skyrocketing price-to-earnings (P/E) ratios, he suggested that U.S. treasury bonds (yielding 7% at the time) offered a much better deal. Then he created a hybrid strategy, explained in his 1998 book *Beating the Dow with Bonds*. Like the previous title, it came with a solidly back-tested claim: following the new strategy from 1969 to 1998 would have gained 23% annually, compared to 18% for the Dogs of the Dow and 13.5% for the S&P 500.

Neither the original Beating the Dow strategy, nor the bond variant, is diversified, however. The second strategy relies on only one asset class at a time—you're fully into stocks or fully into bonds. O'Higgins determined which based on the market's earnings yield (inverse of the P/E ratio) and the price of gold. If the earnings yield on a 10-year government bond is lower than on the S&P 500, then the portfolio goes into stocks. If, however, the government bond yield is higher, then all the money goes into short-term or long-term government bonds. Gold's recent price movement guided the length of the term. From 1968 to 1997, O'Higgins noted, investors lost money in long-term government bonds nine times in 29 years. But if they had used gold as a barometer, and bought short-term bonds when gold rose in price and long-term bonds when gold fell, they would have made money in 28 of those 29 years.

As with the original dogs, one year after selecting the portfolio, the process would be re-evaluated and repeated.

Beating the Dow with Bonds (BTDWB) proved timely, saving its followers from the millennium's first bear drop (2000-2002). From its publication to April 5, 2012, the method would have gained 82.3% cumulatively, compared to 75.7% for the S&P 500.

THE 47% BEATING THAT THE BTDWB STRATEGY took in 2008, however, convinced O'Higgins he had more work to do. So he created a more diversified approach that could weather market plunges. His latest strategy is best suited for investors seeking stability, decent returns but lower risk.

MOAR has so far not been documented in a book (all O'Higgins has is an outline), but this is how it works: first, rank the world's stock markets using O'Higgins's proprietary valuation screen, which will soon be accessible on his website, www.ohiggins.com. Next, select the bottom five indexes—the dogs of the world. Forget your notion of promising markets; O'Higgins guides you to the barrel scrapings. Then combine those with other investments to create the following portfolio:

- 25% Dogs of the world
- 25% Platinum or gold
- 25% Long-term government bonds
- 25% Mid-term government bonds

FROM 1973 TO 2012, O'HIGGINS'S ORIGINAL DOGS OF THE DOW STRATEGY WOULD HAVE EARNED SEVEN TIMES THE RETURNS OF THE S&P 500 INDEX

The portfolio should be rebalanced annually back to the original allocation, unless the stock market indexes show overall losses for the year. If that happens, you would shift more assets to stocks. Remove 15% from the other asset classes in equal proportion—5% from the gold/platinum, 5% from the long-term bonds and 5% from the medium-term bonds—and distribute the proceeds equally among the dogs of the world. If the stocks drop for a second year, you'd remove a further 15% from metals and bonds, giving the stocks a far heavier representation to take advantage of cheap market levels—so as to win higher profits when stocks recover.

Following such a strategy, to borrow Warren Buffett's expression, would ensure you are always greedy when others are fearful, and fearful when others are greedy. The above diversified portfolio would have gained 27% in 2009 and 12% in 2010, after losing less than 1% in the terrible 2008. What's more, in the past 39 years, it would have suffered only three mildly losing years, without a single year's loss exceeding 5%.

Last year, the MOAR strategy gained 8.6% while most of the world's stock market indexes had double-digit losses. Because the stock portion of the strategy fell in 2011, the portfolio would this year take a heavier weighting of stocks. Including a collection of ETFs, here's what the portfolio looked like in January:

- 40% Dogs of the world: 8% France (EWQ); 8% Poland (EPOL); 8% Spain (EWP); 8% Russia (RSX) ; 8% Italy (EWI)
- 20% Platinum (PPLT)
- 20% Long-term government bonds
- 20% Intermediate-term government bonds (Canadians may want to replace the U.S. bond indexes with Canadian fixed income)

Passive investing strategies like this one, according to O'Higgins, make plenty of sense. Few professional investors can beat the market after fees and bid-ask spreads. Toss in a healthy amount of diversification, and you should have the elements of a solid portfolio. If nothing else, O'Higgins has proven that dismal market outlooks can produce generous investment returns. ◗

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