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MIDF AMANAH INVESTMENT BANK BERHAD

QUANTVIEW

MIDF EQUITY STRATEGY | 9 DEC 2016

Dogs of the Dow:

- The Dogs of the Dow (DOD) is an investment strategy that picks out the top 10 stocks in the Dow Jones Industrial Average (DJIA) with the highest dividend yield. This strategy believes that blue-chip companies generally do not adjust its dividend outlay based on trading conditions despite the fluctuation in stock prices throughout the business cycle. Thus, the dividend is used as an indicator to measure the average worth of the company.

- Companies with a high dividend yield would most probably attain higher price returns in the coming year (as it is believed that these companies are approaching the bottom in their business cycle) compared to companies with lower dividend yield. The top 10 highest dividend yield stocks will then be determined at the end of the year and held for a period of one year in the following year.

09 December 2016 | Strategy - Quant

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Dogs of the Dow effect

High yield blue-chip stocks

FBM KLCI: 1,643.75 points

2016 Year-end Target: 1,700 points

Investment Strategy Information	
Macro Strategy	Passive Investment Strategy
Strategy/Effect name	Dogs of the Dow
Strategy Type	Dogs of the Dow, Dividend yield
Back Test Period	15 Years
Rebalanced	Every year
Results Tabled	Summary based on 15 Years data
Period Start	31 December 2000
Period End	31 December 2016
Index Observed	1 - FBM KLCI Index
Stocks Observed	179 - FBM KLCI Components
No. of observations	10,770
Average observation per stock	60

- **Dogs of the Dow.** The Dogs of the Dow (DOD) is an investment strategy that picks out the top 10 stocks in the Dow Jones Industrial Average (DJIA) with the highest dividend yield. This strategy believes that blue-chip companies generally do not adjust its dividend outlay based on trading conditions despite the fluctuation in stock prices throughout the business cycle. Thus, the dividend is used as an indicator to measure the average worth of the company. Companies with a high dividend yield would most probably attain higher price returns in the coming year (as it is believed that these companies are approaching the bottom in their business cycle) compared to companies with lower dividend yield. The top 10 highest dividend yield stocks will then be determined at the end of the year and held for a period of one year in the following year.

- **Other variations of DOD.** There have been several variations (in efforts to refine the outcome) of this strategy. Among them are the (i) Dow 5, which consists of the lowest priced stocks in the DJIA; (ii) Dow 4, which consists of the highest priced stocks of the Dow 5; and (iii) the Foolish 4, which consists of the same stocks as the Dow 4, but allocates 40% of the portfolio to the stock with the lowest price and 20% to each of the remaining three stocks. However, in our study for implementation in the Malaysian market, we have applied the top 10 dividend yield strategy.

- **Outperformed the FBM KLCI in eight out of fifteen years.** Based on a 15-year quantitative study, not all of the 10 selected FBM KLCI constituents exhibited positive price return in the following year despite having a high dividend yield. The number of years the average percentage returns of top 10 stocks outperformed the returns of the FBM KLCI are eight out of the fifteen years of study, i.e. 53% occurrence.

- **The highest average total return was in 2003 (from stocks chosen on 2002 dividend yield).** As per the results of our analysis, the year with the highest average percentage return of top 10 stocks was in 2003 at +45.3%, outperforming the FBM KLCI return by a whopping +22.6ppts.

RECOMMENDATION

- **Slightly better than an even chance of outperformance.** Predicated on the empirical returns behaviour, there is a 53% chance that a DOD-based portfolio (of top 10 FBM KLCI constituents) would outperform the FBM KLCI.

- **Top 10 picks.** Based on our ranked dividend yield among FBM KLCI constituents, we list below our top 10 stock picks for 2017 to take advantage of the DOD strategy:

Table 1: Stock Picks for 2017 DOD strategy

Stocks	Price (RM) 8-Dec-2016	Expected Dividend per share (sen)	Expected Dividend Yield (%)	Target Price (RM)
YTL Corp	1.58	10.25	6.5	1.50
Malayan Banking	7.9	47.00	5.9	8.10
KLCC Property	7.8	34.86	4.5	7.30
DiGi.Com	4.99	21.90	4.4	5.02
Astro Malaysia	2.78	12.00	4.3	3.78
British American Tobacco	44.98	180.00	4.0	41.27
CIMB Holdings	4.64	17.00	3.7	5.90
Ambank Holdings	4.45	15.875	3.6	4.55
Maxis	6.05	21.00	3.5	6.55
Westports Holdings	4.35	15.00	3.4	5.00

Source: Bloomberg, MIDFR

- **FBM KLCI year-end targets.** We reiterate our FBM KLCI 2016 year-end target at 1,700 points which equates to PER16 of 17.0x as well as our 2017 year-end target of 1,830 points which equates to PER17 of 17.0x.

Macro Strategy	:	Passive Investment strategy
Strategy Types	:	Dogs of the Dow, Dividend yield
This Strategy	:	Dogs of the Dow
Strategy Concept	:	The Dogs of the Dow (DOD) strategy encompasses of investing in the top 10 stocks in the Dow Jones Industrial Average (DJIA) that have the highest dividend yield. To implement this strategy in the Malaysian market, we have chosen the top 10 stocks with the highest dividend yield in the FBM KLCI. This strategy believes that blue-chip companies generally do not adjust its dividend outlay based on trading conditions despite the fluctuation in stock prices throughout the business cycle. Thus, the dividend is used as an indicator to measure the average worth of the company. Companies with a high dividend yield would most probably attain higher price returns in the coming year (as it is believed that these companies are approaching the bottom in their business cycle) compared to companies with lower dividend yield..
Strategy Studies	:	Various studies related to the DOD strategy suggest that this is one of the most well-known, simplest yet diversified, investment strategies. By breaking down the term Dogs of the Dow, the “Dogs” refers to the losers and “Dow” refers to the DJIA. This is because stocks with the highest dividend yield imply a lower price compared to other stocks.

The DOD strategy is a popular strategy among international investors. The portfolio of DOD has been found to outperform the DJIA on numerous occasions (Soomro and Haroon, 2015). This investment strategy has also been tested on the Karachi Stock Exchange (KSE) 100 of Pakistan, Standard and Poor’s (S&P) 500 and Stock Exchange of Thailand (SET) 50.

The study carried out by Soomro and Harun, during the period of 2002-2005 showed that the DOD stocks outperformed the DJIA slightly, however, underperformed the S&P 500 and the KSE 100. Meanwhile, during the period of 2009-2011, the DOD of SET 50 and KSE 100 outperformed its respective markets in two years (2009 and 2011).

According to the study carried out, the portfolio of the ‘Dogs’ appeared to outperform the KSE 100 index only when there had been a phenomenal rise in activities (Soomro and Haroon, 2015). These activities include the financial and economic stability of the country. According to Soomro and Haroon, it can be concluded that financial and economic crisis and other worse market conditions have their bad impacts all over the world and while analysing the whole data it is suggested that investor should be advised by a professional investment guide before implementing DOD strategy.

Another explanation to this strategy is that the ‘Dogs’ term under DOD refers to losers since those 10 highest yielding shares implies the lower prices currently possess by those shares (Muhammad Ghouse and Ahmad, 2015). One of the requirements of the usage of dividend yield in this strategy is that dividends can still go up despite the fall in earnings. According to Muhammad Ghouse and Ahmad, this indicates that the demand for respective shares will fall once there is a decrement in earnings reported by those companies, which will further reduce the shares prices since earnings’ level is one of the main driver of the dividend’s level.

The DOD investment strategy is a plan on building up a portfolio which consists of undervalued or out-of-favoured shares whose share prices are expected to rise when the market is in a favourable condition. This is a short-term investment strategy due to the rebalancing of the portfolio at the end of each year to accommodate for the ten highest dividend yield stocks for the current year. Due to the short-term characteristic of this strategy, the DOD strategy is considered to be a riskier investment compared to other strategies (Muhammad Ghouse and Ahmad, 2015).

This strategy is also categorized as a contrarian strategy as one of the main contrarian indicators is the high dividend yield (Muhammad Ghouse and Ahmad, 2015). A high dividend yield represents lower share prices and most probably signifies that a company is at its lowest in a business cycle. The fact in which investors are referring to the dividend yield of the company shows that they are not confident in the earnings of the company (Muhammad Ghouse and Ahmad, 2015).

According to Muhammad Ghouse and Ahmad, the DOD strategy is also known as a value investment strategy due to the high yielding shares. Among the characteristics of value shares are (i) low price-to-book ratio, (ii) low price-to-earnings ratio, and (iii) high dividend yield. Investors will usually overreact negatively towards undesirable company financial news causing a downward market price movement and vice versa, thus, the former overreaction will create value shares (Muhammad Ghouse and Ahmad, 2015).

This Study Rationale	:	Based on the studies available, it can be concluded that the DOD strategy might not always outperform the respective market index. As for the case in Malaysia, by implementing the strategy to the FBM KLCI, the DOD stocks only outperformed the market in eight out of the fifteen years of study. This shows that the implementation of the DOD strategy in the Malaysian market produces slightly better than an even chance of outperforming the FBM KLCI.
Findings Overview	:	DOD strategy provides a fair (53%) chance of outperforming the FBM KLCI
Back Test Period	:	15 Years
Rebalanced	:	Every year
Results Tabled	:	Summary based on 15 Years data
Period Start	:	31-December-2000
Period End	:	31-December-2015
Index Observed	:	1 – FBM KLCI Index
Stocks Observed	:	179 – FBM KLCI Consitutents from 2000 until 2015
No. of observations	:	10,770
Ave. obs/stock	:	60

Table 2: Results of back-testing the DOD strategy on FBM KLCI

Year	DOD Return (%)	FBM KLCI Return (%)	Variance
2001	14.4	2.9	11.5
2002	7.6	(7.0)	14.6
2003	45.3	22.7	22.6
2004	7.0	14.4	(7.4)
2005	(4.3)	(0.8)	(3.5)
2006	35.5	21.9	13.6
2007	28.8	31.8	(3.0)
2008	(13.4)	(39.3)	25.9
2009	17.1	44.9	(27.8)
2010	14.9	19.4	(4.5)
2011	16.2	0.4	15.7
2012	21.5	10.9	10.6
2013	3.7	10.8	(7.1)
2014	(2.6)	(5.6)	3.0
2015	(9.9)	(3.7)	(6.3)

Source: Bloomberg, MIDFR

Findings

Overall : For the period reviewed, the results prove that the Dogs of the Dow (DOD) strategy provide a fair (53%) chance of outperforming the FBM KLCI.

Annual returns

1. The average annual returns for the top 10 dividend yielding FBM KLCI component stocks (revised at the end of each year based on dividend yield) had occasionally outperformed the FBM KLCI.

2. For the 15-year period reviewed, the highest average annual return of the DOD stocks was at +45.3% in 2003 (the top 10 highest dividend yielding stocks in 2002). Moreover, the DOD stocks outperformed the FBM KLCI by +22.6ppts in 2003 (selections of 2002). While the lowest average annual return of the DOD stocks was at -13.4% in 2008 (selections of 2007), it still outperformed the FBM KLCI by +25.9ppts.

3. The table above shows that the DOD components outperformed the FBM KLCI for eight years out of the fifteen years, representing 53% of the study period.

4. Among the stocks which had been selected as DOD component for 10 or more times were British American Tobacco (Malaysia) Berhad, Telekom Malaysia Berhad and DiGi.Com Berhad. The total returns for these three stocks in 15 years are +26.4%, +94.5% and +937.5% respectively.

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