The DARLINGS of the DOW

No dogs here! A well-known futures trader discusses the results of a half-dozen years of research that led to the development of a fundamentally based and technically enhanced stock-selection model that outperforms the Dow while reducing volatility.

BY LARRY WILLIAMS

Have you been bitten by the bug of finding stocks that make extraordinary gains? It sometimes seems our entire society — and the financial media in particular — have become obsessed with chasing promises of stratospheric gains.

However, making money in the stock market is not nearly as much about finding stocks that go up as it is about avoiding stocks that go down. Those few, select stocks that hold up when other stocks are collapsing are the true market "darlings" investors should want to date.

Unfortunately, the average investor or trader is constantly bombarded with stories about killings being made in the market — about people who started with almost no money and traded their way to substantial fortunes.

The reality, however, is that these stories are the exception, not the rule. But that doesn't stop people from believing these dreamy stories and ignoring what is actually possible in the market. While it is true that some people make it big, to think that most of us can perform equally well — on a consistent basis — is nothing more than a case of being fooled by randomness.

However, there is a realistic investment strategy investors and traders can use to produce above-average returns and below-average risk. It has nothing to do with looking for momentum or "hot stocks." The key is to know the characteristics of stocks you should avoid and the stocks on which you should concentrate. It's about looking for value — because ultimately, value is rewarded.

A stock that goes up never hurts anyone

Most new investors and traders approach the market with the same idea: Find stocks that should go up — a lot. However, different stocks may go up at different times for different reasons, which makes keeping tabs on the strongest stocks a labor-intensive guessing game.

One harsh, immutable statistic brings the investment challenge into focus: Approximately 80 percent of mutual funds can't outperform the lackluster Dow Jones Industrial Average (DJIA). If all those hot-shot fund managers — armed with MBAs, Ph.D.s, whirring computers and sophisticated investment programs — can't beat the averages, you have to ask yourself: What's wrong with their basic approach and how can I do better?

The first part of the answer is to stop looking for stocks that go up and start looking for those that don't go down. The idea is that by doing so you will avoid or sharply limit risk, and

thus come out ahead of the long-term investing pack. After all, stocks that go up never hurt anyone. It's the ones that get clobbered that hurt our performance, pocket books and egos.

Let the high-flyers fly away

Here's an interesting thought to start our search: If you eliminated the five or six worst-performing stocks of each year from the DJIA, you would be left with the "Darlings of the Dow" and superior market performance that beats the pants off the fund managers.

These stocks are not high-flying big winners reported on the news or obsessed over on the message boards. The truth is that big winners have a distressing tendency to turn into big losers — they have no consistency.

Market history clearly shows that high flyers are extremely risky investment vehicles. Invariably they take nasty falls. Try to find a true high flyer that kept flying — ever. They all get tagged, and many end up filing for bankruptcy. Investing in high flyers is like shooting craps — eventually a 7 shows and investors, private and professional, are left holding a bag full of nothing.

There's no getting around the truth that the greater the reward, the greater the risk.

Market performance: The mathematics of losing

Consider just how damaging a few crashed stocks can be to your performance. If you have a $1 million portfolio and decide to place only 30 percent of it in risky high-flyers, you may do very well — for a while.

However, when these hot stocks eventually turn cold it is not unusual for them to lose 50 percent or more of their value. The collapse of Enron is nothing new in the world of high-flying stocks. Almost all the high flyers of the late 1960s and early 1970s are out of business or have become stocks that are no more than low-priced backwaters. The same is true of the rip-and-run stocks of the 1980s. You can judge for yourself about the tech stocks of the 1990s.

Some people suggest dealing with this risk by placing only part of their assets, typically around 30 percent, in such stocks. However, if you lose 50 percent of the 30 percent you placed in these issues, that wipes out 15 percent of your total equity.

Then consider this sobering fact: On average, a long-term buy-and-hold strategy produces a 9-percent annual gain in the DJIA. That means on average you'll have to wait 19 months to get back to breakeven on your portfolio after losing that 15 percent — and that's if you were wise enough to plunk down only 30 percent of your account on the latest craze. What if you put 50 percent of your capital into these soon-to-be dogs? It will be years before you get your money back.

That's a hypothetical situation. Market reality is often much worse. The investor who bought Qualcomm at 175 to see it slither to 38 has learned about 7s coming up. Intel investors took a 63-percent hit when the stock dropped from 72 to 26. Even supposed "blue chips" are not immune. Microsoft has suffered a 63-per-

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By the numbers

Price-to-sales ratio:	Stock price divided by revenues per share.
P/E ratio:	Stock price divided by earnings per share.
Price-to-book ratio:	The current closing price of the stock divided by (usually) the latest quarter's book value (assets minus liabilities). Used to compare a stock's market value to its book value.
Price-to-cash-flow ratio (or "cash-flow ratio"):	Price per share divided by cash flow per share. (Cash flow is the amount of cash a company creates and uses over a certain period. It is calculated by adding non-cash charges (e.g., depreciation) to after-tax net income.
Dividend yield:	Annual dividends per share divided by price per share.

Strategy Snapshot

Name:	Darlings of the Dow
Type:	Long-term investing
Market:	Dow Jones Industrial Average (DJIA) stocks.
Fundamental criteria:	Buy high-yield, low-priced stocks that also have low P/S ratios and low cash-flow ratios.
Technical criteria:	Enter in the last week of October and exit on the first day of the following May to capitalize on the October-May stock market seasonal.

TABLE 1 DOW STOCKS, 1976-2001

A comparison of buying Dow stocks with different fundamental characteristics helps highlight which stocks to avoid and which to buy. The price-to-sales (P/S) ratio is most effective for identifying stocks not to buy. Also, low dividend yields and high P/E ratios impeded profits.

Buy 5 lowest yield	Buy 5 highest yield (Dogs of the Dow)
+11.13%	+15.95%
Buy 5 highest P/E	Buy 5 lowest P/E
+14.6 %	+15.99%
Buy 5 highest P/S	Buy 5 lowest P/S
+10.7%	+15.74

cent decline and staid stocks such as Merck have seen numerous declines of 40 percent or more in their history.

Now you know why momentum-chasing investors invariably are wiped out and why mutual funds suffer severe damage: They over-invested in the hot stocks of the day. Doing this is the equivalent of walking a tightrope over a dangerous stretch of the Amazon: If you go down, the odds aren't good of coming back up.

Where, then, should an investor or trader focus? The answer is to forget the notion of buying a stock because it gained more than another one; don't hop aboard the momentum train. The first one now will later be last.

Instead, find out why stocks go down and concentrate on those stocks that are not likely to drop. In other words, let value drive your approach.

Shopping for value

With this goal in mind, the DJIAstocks are an attractive group on which to focus. After all, they are not high flyers (hey, who let Microsoft in there, anyway?); they are substantial companies, not subject to every whim of the marketplace. These are real companies, with real products and real performance records going back many years.

There are many ways to assess a stock's strength. In looking over these measures, one thing became extremely clear, thanks in part to James P. O'Shaughnessy's wonderful writings on stock selection: Stock valuation measures separate winners from losers. O'Shaughnessy's studies backed up the legendary work of Benjamin Graham, whose entire focus was on value rather than technical analysis, hot stocks or momentum plays.

O'Shaughnessy's major contribution was to show the differences between buying stocks based on different fundamental characteristics — say, high yields, low yields, or high price-to-sales (P/S) ratios. (For more information on this ratio and other value measures, see "By the numbers," p. 85.) He dubbed the last ratio the "King of Value." This measurement, in fact, makes it possible to identify stocks that are most likely to decline. Extensive testing shows that stocks with high P/S ratios perform the worst. They are the stocks you should avoid.

Long live the king

The price-to-sales ratio compares the price of the stock to its annual sales. Although O'Shaughnessy popularized the P/S ratio within the professional community, it has yet to catch on as standard cocktail-party chatter among individual investors and traders. (The next time someone tells you about a stock they just purchased, ask him or her what its P/S ratio is. Chances are, they won't be able to tell you.) Most investors are much more familiar with the P/E ratio, which compares the price of a stock to its earnings (a la the Graham techniques of the 1930s).

According to O'Shaughnessy, a low P/S ratio (below 2.0) implies a fundamentally strong company. This assessment is essentially accurate, but there are other value measures that, when analyzed together, provide a more complete picture of a stock's condition: the aforementioned P/E ratio, the price-to-book ratio, price-to-cash flow ratio, and the dividend yield. As we will see shortly, a weighted blend of these calculations can produce good results. First let's take a quick look at the old standards, dividend yield and the P/E ratio.

Table 1 (left) shows the results of a study of DJIAstocks from 1976 to 2001. The test was to buy the five DJIAstocks with the lowest and highest dividend yield, P/E ratio and P/S ratio. The differences are obvious. (The approach of buying the five or 10 highest-yield stocks is popularly known as the Dogs of the Dow strategy.)

This study clarifies several things. First, yes, P/S is critical, but more in terms of avoiding losers than finding winners; in other words, the P/S ratio can ferret out stocks not to buy. After all, the "good" values for the dividend yield and P/E ratio produced higher rates of return than the low P/S. Other impediments to market profits are low yield and high cash flow, as will be discussed shortly.

A second test consisted of taking the stocks with the "bad" P/S and P/E ratios and buying the five with the highest relative strength ratings, which essentially combines the concept of positive current momentum with lack of value — the classic combination of high-flying stocks.

Could momentum overcome the fact that low-yield stocks don't do well? Table 2 (below) shows the results of buying high P/S and high P/E stocks that have been relatively stronger than other stocks over the past six months. Based on the results, the combinations of momentum and high P/E ratios should certainly be avoided. Momentum could not bail out these stocks from their lack of value. In fact, these combinations produced the poorest performance of all.

Can the market be timed?

The studies in the previous sections (along with a few others)

TABLE 2 MOMENTUM IS NOT THE ANSWER

A second test shows the results of buying stocks with "bad" (high) P/E ratios and (low) dividend yields, combined with high relative strength, or momentum. Compared to the first test, it's apparent that strong momentum cannot compensate for bad P/E or yield numbers.

Buy 5 highest-P/E momentum stocks	Buy 5 lowest-yield momentum stocks
+7.75%	+12.06%

make a strong argument for approaching stock investing with a fundamental perspective. But many technical investors and traders (such as the author, who has been following the market since 1962 and trading it for a living with technical analysis since 1966) will naturally want to meld the two disciplines.

Some technicians claim they can predict the majority of market highs and lows, but few (if any) can show evidence of being able to do so on a consistent basis. Fundamentalists say it cannot be done at all. However, some market timers are right significantly more than they are wrong.

An honest appraisal would probably be that it is possible to time the market, but it is easier to do it on a one- to two-day basis than a three- to five-year basis, simply because there are a million unknowns over the next five years, far fewer over the next two days.

From a broad perspective, one of the most reliable long-term timing tools is the strong seasonal pattern in the stock market. This is certainly not a new discovery. Edgar Smith may have been the first to take note of this phenomenon in his delightful writings back in 1938. In the mid-1960s Art Merrill wrote of the tendency of stocks to rally most often from an October low point to a May-June market peak. Yale Hirsch, in his *Stock Traders Almanac* (always chock-full of goodies), has shown this exact pattern from 1967 forward.

These men proved that although nothing in the market is always true, the way to bet is that stocks will start rallying some time in October.

The value-measure tests summarized in Tables 1 and 2 are based on buying the last week of October and exiting on the first trading day of May. There are other, more optimal strategies, but they all prove the same point: You get more bang for your buck during the October-May period than any other.

This point is illustrated by Figure 1 (right), which shows the seasonal tendency of the S&P 500 cash index from 1960 forward. History is not always repeated, but it does provide an invaluable road map for investors and traders. Considering the October buy zone was

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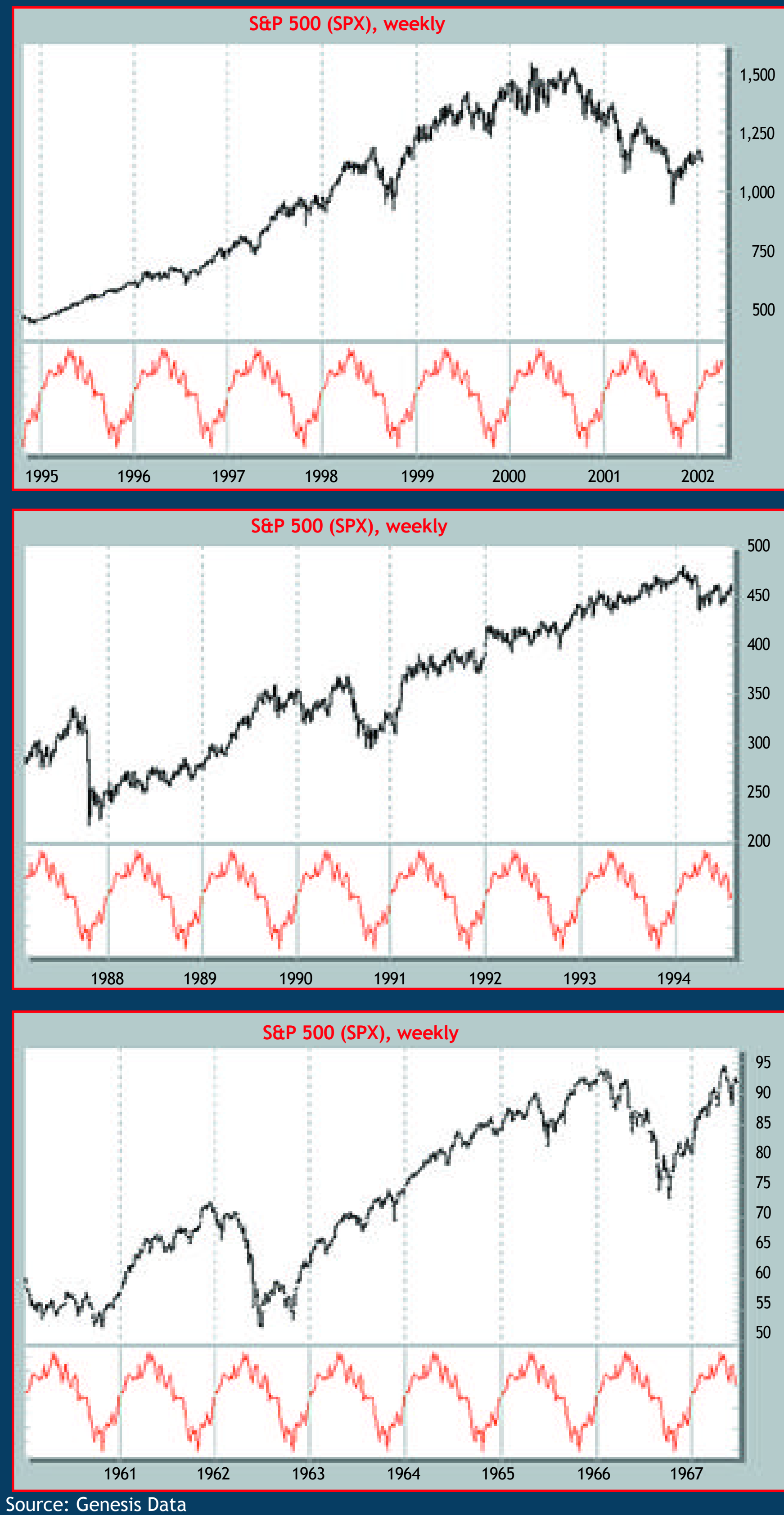
FIGURE 1 SEASONAL TENDENCIES

Decades of data supports the tendency of stocks to rally from October to May. This broad timing tool can be added to a valuation-based stock selection model to increase returns and reduce risk.



Source: Genesis Data

TABLE 3 FUNDAMENTALLY DIFFERENT

The Darlings of the Dow finds low-priced stocks with high dividend yields, P/S ratios and low cash-flow ratios. From October 2000 to May 2001, the Darlings of the Dow returned 15 percent, while the DJIA returned 5.53 percent and the Dogs of the Dow approach lost -4.9 percent.

Stock	Price October 2000	Price May 2001	Return
Phillip Morris (MO)	34.75	46.25	33.09%
Kodak (EK)	39.06	39.5	1.13%
Caterpillar (CAT)	31.43	44.81	42.57%
General Motors (GM)	56.25	52.56	-6.56%
Dupont (DD)	40.68	42.63	4.79%
Net:			15.00%
DJIA:			5.53%
Dogs of the Dow:			-4.9%

first written about in 1938, the ensuing 64 years of "out-of-sample data" have held up quite well.

Timing the market with this seasonal pattern not only pays off in high returns, but also in reduced risk. If you bought only the five DJIA stocks with the highest yields and the lowest cash-flow ratios at the end of October and exited six months later, your average annual return would have been 18.7 percent. The rest of the time you would be in cash, collecting at least 2 percent on your money, to net 20.7 percent per year, on average.

Not only is your return high, you also miss the crashes of 1966, 1969, 1970, 1973, 1974, 1977, 1981, 1987, 1990, 1998, 1999, 2000 and 2001. This sailing is as smooth as you are likely to get in the seas of high finance.

Improving the selection criteria

On the surface, this approach resembles the highly popular Dogs of the Dow strategy. But adding two vitally important twists creates a unique strategy: the Darlings of the Dow.

TABLE 4 2001-2002 DARLINGS OF THE DOW

Through Feb. 8, 2002, the Darlings of the Dow had posted a -2.03-percent return, compared to 2.97 percent for the DJIA and -2.30 percent for the Dogs of the Dow.

Stock	Price Oct. 25, 2001	Price Feb. 8, 2002	Return
Kodak (EK)	31.29	27.45	-12.27%
Dupont (DD)	40.30	42.72	6.00%
General Motors (GM)	44.63	49.85	11.70%
JP Morgan (JPM)	37.48	31.12	-16.97%
Phillip Morris (MO)	49.39	50.07	1.38%
Net:			-2.03%
DJIA:			2.97
Dogs of the Dow (Jan. 2-Feb.8, 2002):			-2.30

The first twist is to time the entry and exit by using the October-May seasonal. After all, what's the magic of buying stocks just because it's the first of the year, which is the entry for Dogs of the Dow strategy?

The year 2001 proved this point in spades. The Dogs of the Dow lost 4.9 percent while the Darlings of the Dow approach purchased the stocks shown in Table 3 (top left) in October 2000 for a net gain of 15 percent. (Adding half the yield to the average net gain shown in the table raises the gain to 17.14 percent). Table 4 (bottom left) shows the stocks and results for October 2001 through Feb. 12, 2002.

The dividend return on these five stocks will be an additional 2 percent; you can watch how they perform to a theoretical exit in late May or early June. (You can track the weekly results at www.larrywms.com).

The second twist seeks to improve performance by incorporating value measures other than yield, as is the case with the Dogs of the Dow. By contrast, the Darlings of the Dow selects high-yield, low-priced stocks that also have low P/S ratios and low cash-flow ratios. The technique is simple: Subtract the P/S and cash-flow ratios from a stock's yield. The stocks with the highest figures are the ones to buy — when the time is right.

For example, say you have two stocks, each with 4-percent yields. One has a cash-flow ratio of 1.5 and a P/S ratio of 2.0. Subtracting these figures from the 4-percent yield results in +.5. The second stock has a 6.0 cash-flow ratio and a 2.0 P/S ratio for a total of 8.0. Subtracted from 4 percent, this stock's final figure is –4.0, which tells us the first stock is likely the better deal.

This approach is not just about buying high rate-of-return stocks. It's about buying the most fundamentally sound stocks, which should also be the stocks that are the least resistant to declines. Will they rally as much as some other stocks? Probably not. You can always find hotter stocks, but hot stocks have too much downside risk. (Also, hot stocks are almost always "discovered" after the fact, when they are about to top out. Remember, increased reward always insures increased risk.)

The "Darlings" approach is a kind of market expression of the request, "God grant me serenity." But in this case, the request is, "God grant me stability." If you get market stability, serenity will follow. As the year-by-year returns in Table 5 (opposite page) show, the rate of return is ample and, most importantly, beats the Dow itself.

Traders take note

Short- and intermediate-term traders can use much of this strategy to pursue speculative profits. The Darlings of the Dow approach gives you an advantage in both stock selection and market timing. Although these stocks may not make the big price moves of the high- or low-flying wonders, they also don't unexpectedly burst at the seams. What they lack in volatility they more than make up for in stability.

The cyclical moves of the Darlings are more predictable. Once these stocks embark on trend moves it is less likely they will quickly end because they are not in the limelight; they are under media-hype radar.

TABLE 5 DARLINGS OF THE DOW, 1980-2001

The strategy produced an average annual gain of 18.6 percent while only being in the market six months of each year. Only three years out of 21 (not counting the 2001-2002 trade) were losers.

Year	Return
1980	27.12
1981	42.9
1982	3.14
1983	43.36
1984	31.9
1985	10.29
1986	-8.56
1987	15.9
1988	12.52
1989	15.88
1990	17.8
1991	30.36
1992	-8.36
1993	10.18
1994	11.18
1995	-4.02
1996	39.46
1997	14.67
1998	0.192
1999	67.29
2000	17.53
Average:	**18.61**

Correct timing is the ultimate secret of successful short-term trading. Going long from late October to late April or early May — when it has been most successful to work the long side of the market — is a powerful tool for short-term traders. Short sellers can concentrate on the downside of the market in the May to mid-October period. By doing this you keep yourself in phase with the strongest seasonal pattern the markets know.

Just the beginning

The results in Table 5 are not the end of the story. Other fundamentally based approaches can be used to enhance the Darlings of the Dow model.

For example, you can add an average gain of 5 percent to the yearly returns by moving into various groups of similarly selected stocks that have shown a strong seasonal tendency to rally from April-May into early October, thus netting approximately 25 percent a year on average.

When it comes to consistent returns over time, forget about momentum and flying high. Stick close to the ground and remember that value comes out on top in the end.

"Darlings of the Dow" is a registered trademark. For more information on the author *see p. 10.*