



Market Bulletin

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*** Happy New Year ***
Best wishes for a successful and prosperous 2014!

Special Report – The “Dogs of the Dow” and the “Hounds of the TSX”

Dogs and Hounds outperformed the DJIA and TSX respectively in 2013

Dow Dogs at higher valuations compared with a year ago; Hounds' valuations little changed

Dow Dogs continue to offer better diversification; Hounds still dominated by energy sector

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As we did a year ago, our first Bulletin of 2014 looks at the well-known “Dogs of the Dow.” This is an investment strategy that involves investing equal amounts in the 10 stocks on the Dow Jones Industrial Average (DJIA) with the highest dividend yields at the start of the year, and holding them until the end of the year. At year-end, the strategy calls for rotating out of that year’s Dogs and deploying the proceeds into the new Dogs for the year ahead. A similar investment rule applied to the TSX-60 produces what we call the “TSX Hounds.”

The basic premise of the Dogs of the Dow strategy is that blue chips with above-average dividend yields may be going through a temporary rough patch; once their operating performance and fundamentals improve, the consequent rebound can lead to substantial total returns. The strategy relies on buying the top 10 highest dividend yielders – rather than just one or two of the highest yielders – as a measure of diversification.

Some turnover does occur in the Dogs from one year to the next, generally because the dividend yield on some stocks has declined due to share price appreciation or a dividend cut. Reshuffling of the Dow Dogs can also take place when stocks leave the index, as was the case with 2008 Dogs Citigroup and General Motors, which were jettisoned from the DJIA in 2009.

So how has the strategy fared over time? While one would expect the Dow Dogs to outperform in choppy, uncertain markets, and underperform in ebullient, bullish markets, the strategy has outperformed consistently across all time periods since 2000 (Table 1). This may largely be due to the confluence of two major investment themes in recent years – (i) the demand for high-yield instruments in an era of record-low interest rates, and (ii) investor preference for solid, blue-chip stocks rather than more speculative shares.

In 2013, the Dow Dogs and the TSX Hounds outperformed the broader indices. The Dogs of the Dow posted total (average) returns of 34.98% for the year, compared with 29.65% for the DJIA itself and 32.38% for the S&P 500. (In 2012, the Dogs returned 10.1%, which was better than the DJIA's 7.9% total return but less than the S&P 500's 16.0% return).

(Note that there is slight slippage between the average returns of 34.87% for the Dow Dogs in 2013, as shown in Table 2, and the 34.98% return computed by the "Dogs of the Dow" proxy index – the DJ High-Yield Select 10 Total Return Index (symbol MUTR) – probably due to the method of calculation of the index).

The Hounds of the TSX outperformed the broader indices by a bigger margin, making up for their underperformance of 2012. **The Hounds generated total returns on average (Table 3) of 19.87%, compared with 13.26% for the TSX-60 and 12.98% for the TSX Composite.** In 2012, the Hounds only averaged total returns of 0.1%, compared with total returns of 8.1% for the TSX-60 and 7.2% for the TSX Composite.

Similar to 2012, the 2013 TSX Hounds had greater variability in their returns than the Dow Dogs. Enerplus rebounded from its 50% plunge in 2012 for the best performance among the 2013 Hounds, while Sun Life Financial was among the top two performers for the second year in a row. Penn West ranked among the worst two stocks for the second year running, while TransAlta was the only other stock among the 2013 Dogs and Hounds to post negative returns for the year. Among the 2013 Dow Dogs, Hewlett-Packard was the best performer with total returns of over 100%; it was the only Dow Dog to trade at a single-digit earnings multiple at the beginning of the year, with a forward P/E of only 4.1.

Note the following points with regard to the 2014 Dogs and Hounds:

- There are three new entrants among the 2014 Dogs (Table 4), with the three best performers of 2013 – **Hewlett-Packard, DuPont, and General Electric** – replaced by **Chevron Corp, Cisco Systems, and Procter & Gamble**. (Hewlett-Packard was sent packing from the DJIA in September 2013, along with Alcoa and Bank of America; the three Dow components were replaced by Goldman Sachs, Nike and Visa).
- There are two new entrants among the 2014 TSX Hounds (Table 5), with **EnCana and Fortis** replacing **Sun Life Financial and Arc Resources**.
- The composition of the 2014 Dogs and Hounds groups reveals that the former is more diversified than the latter. Similar to 2013, the 2014 Dow Dogs are well represented in pharmaceuticals (3), technology (2), and telecom (2). The energy, consumer staples and consumer discretionary sectors each have one stock among the Dow Dogs.

- The 2014 TSX Hounds continue to be dominated by energy, with five stocks from the sector, unchanged from 2012. Financials and Utilities contribute two stocks each, with one stock from the telecom sector.
- **Combining the 2014 Dow Dogs and TSX Hounds would produce a fairly diversified portfolio with representation from most major sectors except for Materials and Industrials.** Since these are equal-weighted portfolios, a combination would produce the following sector weights – Energy 30% (PWT, COS, CPG, ERF, ECA, CVX), Pharma 15% (MRK, PFE, JNJ), Telecom 15% (BCE, T, VZ), Financials 10% (BMO, CM), Technology 10% (INTC, CSCO), Utilities 10% (TA, FTS), Consumer Discretionary 5% (MCD), and Consumer Staples 5% (PG).
- **Dividend quality of the 2014 Dogs is much better than that of the 2014 Hounds.** All 10 of the 2014 Dogs boosted their dividends last year. Only four of the 2014 Hounds hiked dividends last year – BCE, Bank of Montreal, CIBC, and Fortis. Two of the 2014 Hounds – Penn West and EnCana – in fact slashed their dividends in 2013. In addition, five of the 2014 Dogs are also S&P 500 Dividend Aristocrats (stocks that have raised dividends consistently for a defined number of years) – AT&T, Chevron, McDonald’s, Procter & Gamble, and Johnson & Johnson. However, **Fortis is the only 2014 Hound that is also a component of the TSX Canadian Dividend Aristocrats index.**
- **The 2014 Dow Dogs look pricier than the 2013 Dogs**, with an average forward P/E (based on 2014 forecast EPS) of 13.9, compared with 11.7x. The average 3.41% dividend yield for the 2014 Dow Dogs is also down significantly from 4.06% for the 2013 Dogs. **Valuations for the 2014 TSX Hounds are little changed from those for the 2013 Hounds**, with an average forward P/E of 25.5 (due to outliers like PWT and CPG) compared with 26.8, and a dividend yield of 6.25% (compared with 6.54%).
- **Investors looking to replicate the performance of the Dogs of the Dow strategy could consider the “Elements – Dogs of the Dow” exchange-traded note (ticker symbol DOD, \$13.77)**, which provides returns equivalent to that of the DJ High-Yield Select 10 Total Return Index (MUTR) mentioned earlier. Over the past year, the note has generated a return of 29.85%, compared with 30.42% for the index.

Table 1: Dogs of the Dow vs. DJIA and S&P 500

Total Returns	Dogs of the Dow*	DJIA	S&P 500
2013	34.98%	29.65%	32.38%
Mar. '09 - Dec.'13	294.69%	188.24%	202.64%
2001 - 2013	128.34%	111.19%	80.37%

* Using Dow Jones High Yield Select 10 Total Return Index (MUTR) as a proxy

Table 2: 2013 Dogs of the Dow

Stock	Ticker	Sector	Div. Yield	Price chg.	Total ret.
			(end-2012)	2013	2013
AT&T	T	Telecom	5.34%	4.30%	9.76%
Verizon	VZ	Telecom	4.76%	13.57%	18.64%
Intel	INTC	Technology	4.36%	25.87%	30.88%
Merck	MRK	Pharma	4.20%	22.25%	26.80%
Pfizer	PFE	Pharma	3.83%	22.13%	26.22%
DuPont	DD	Chemicals	3.82%	44.45%	49.16%
Hewlett Packard	HPQ	Technology	3.71%	96.35%	101.11%
General Electric	GE	Diversified	3.62%	33.54%	37.89%
McDonald's	MCD	Consumer Pr.	3.49%	10.00%	13.61%
Johnson & Johnson	JNJ	Pharma	3.48%	30.66%	34.62%
			4.06%	30.31%	34.87%

Table 3: 2013 Hounds of the TSX-60

Stock	Ticker	Sector	Div. Yield	Price chg.	Total ret.
			(end-2012)	2013	2013
Penn West Petro	PWT	Energy	10.00%	-17.87%	-11.44%
Enerplus	ERF	Energy	8.37%	49.61%	60.35%
TransAlta	TA	Utilities	7.67%	-10.85%	-3.49%
Crescent Point	CPG	Energy	7.34%	9.65%	17.74%
Canadian Oil Sands	COS	Energy	6.94%	-0.94%	6.00%
Sun Life Financial	SLF	Financials	5.46%	42.28%	48.85%
BCE Inc.	BCE	Telecom	5.32%	7.91%	13.62%
Arc Resources	ARX	Energy	4.91%	20.99%	26.53%
Bank of Montreal	BMO	Financials	4.73%	16.35%	21.66%
Cdn. Imperial Bank	CM	Financials	4.70%	13.44%	18.87%
			6.54%	13.06%	19.87%

Table 4: 2014 Dogs of the Dow

Stock	Ticker	Sector	Div. Yield (end-2013)	Price (end-2013)	2014 EPS (forecast)	EPS chg. ('14 vs. '13)	Fwd. P/E ('14 EPS)
AT&T	T	Telecom	5.12%	\$35.16	\$2.67	7.66%	13.2
Verizon	VZ	Telecom	4.22%	\$49.14	\$3.49	23.76%	14.1
Intel	INTC	Technology	3.47%	\$25.96	\$1.92	-0.52%	13.5
Merck	MRK	Pharma	3.44%	\$50.05	\$3.49	-0.29%	14.3
McDonald's	MCD	Consumer Disc.	3.22%	\$97.03	\$5.93	6.85%	16.4
Pfizer	PFE	Pharma	3.07%	\$30.63	\$2.29	5.05%	13.4
Chevron Corp.	CVX	Energy	3.04%	\$124.91	\$11.82	3.78%	10.6
Cisco Systems	CSCO	Technology	2.90%	\$22.43	\$2.08	5.05%	10.8
Procter & Gamble	PG	Cons. Staples	2.86%	\$81.41	\$4.67	8.86%	17.4
Johnson & Johnson	JNJ	Pharma	2.77%	\$91.59	\$5.86	6.74%	15.6
			3.41%				13.9

Table 5: 2014 Hounds of the TSX-60

Stock	Ticker	Sector	Div. Yield (end-2013)	Price (end-2013)	2014 EPS (forecast)	EPS chg. ('14 vs. '13)	Fwd. P/E ('14 EPS)
Penn West Petro	PWT	Energy	12.18%	\$8.87	\$0.10	N/A	88.7
TransAlta	TA	Utilities	8.62%	\$13.48	\$0.66	24.53%	20.4
Canadian Oil Sands	COS	Energy	7.01%	\$19.98	\$1.85	-0.54%	10.8
Crescent Point	CPG	Energy	6.69%	\$41.25	\$1.08	44.00%	38.2
Enerplus	ERF	Energy	6.06%	\$19.30	\$0.84	35.48%	23.0
BCE Inc.	BCE	Telecom	5.03%	\$46.00	\$3.16	5.69%	14.6
EnCana	ECA	Energy	4.43%	\$19.18	\$0.92	-7.07%	20.8
Cdn. Imperial Bank	CM	Financials	4.19%	\$90.72	\$8.56	-2.51%	10.6
Fortis	FTS	Utilities	4.14%	\$30.45	\$1.80	7.14%	16.9
Bank of Montreal	BMO	Financials	4.12%	\$70.81	\$6.26	-0.63%	11.3
			6.25%				25.5

Source (Tables 1 to 4): Global Securities Research, Bloomberg

Market Snapshot

At close on Friday, January 3, 2014

S&P TSX	13548.86	-45.33	Commodities			Yields (%)		Can.	US
TSX Venture	944.71	+5.50	Canadian \$ (US cents)	93.99	+0.27	90 Day T-Bill	0.89	0.07	
DJIA	16469.99	+28.64	Gold (Spot)-US\$	1237.01	+12.61	2-Year Bond	1.13	0.40	
S&P 500	1831.37	-0.61	Oil (WTI-Feb.)	93.96	-1.48	10-Yr. Bond	2.75	2.99	
NASDAQ	4131.91	-11.16	CRB Index	276.53	-0.88	30-Yr. Bond	3.21	3.92	

Thought for the Day

"May the best day of your past be the worst day of your future." – Irish toast

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