



The Bigger Picture

A weekly snapshot of the markets

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*** Happy New Year ***

Best wishes for a successful and prosperous 2015

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

2014 Dogs outperformed DJIA, but 2014 Hounds underperformed TSX by huge margin
Five new entrants in 2015 Hounds, and three in 2015 Dogs
Dogs have better diversification and dividend quality; Hounds still dominated by energy
Elvis Picardo, CFA

As we have done for the last two years, our first Bulletin of 2015 looks at the well-known “Dogs of the Dow” strategy. This investment strategy 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 a couple of the highest yielders, in order to improve diversification.

Some turnover does occur in the Dogs and Hounds from one year to the next, either because the dividend yield on some stocks has declined due to share price appreciation or a dividend cut, or because of index reshuffling. For instance, 2008 Dogs Citigroup and General Motors were jettisoned from the DJIA in 2009, while 2013 Hounds Penn West and Enerplus were removed from the TSX-60 in December 2014.

The Dogs of the Dow strategy has outperformed the DJIA and S&P 500 significantly in this millennium (Table 1), perhaps due to the demand for high-dividend stocks in an era of record-low interest rates, and investor preference for blue-chips over more speculative shares. The same, however, cannot be said for the TSX Hounds.

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

Total Returns	Dogs of the Dow*	DJIA	S&P 500
2014	10.84%	10.04%	13.68%
Mar. '09 - Dec.'14	289.23%	193.87%	216.61%
2001 - 2014	153.11%	132.35%	105.00%

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

In 2014, the Dow Dogs outperformed the DJIA but not the S&P 500. The Dogs posted total returns of 10.84% (using the Dow Jones High Yield Select 10 Total Returns Index – symbol MUTR – as a proxy), compared with 10.04% for the DJIA and 13.68% for the S&P 500. (In 2013, the Dogs returned 34.98%, compared with total returns of 29.65% for the DJIA and 32.38% for the S&P 500).

(Note that the slippage between the average 2014 returns of 12.02% for the Dow Dogs in 2014, as shown in Table 2, and the 10.84% return computed by the “Dogs of the Dow” proxy index, grew to 1.18 percentage points, from 11 basis points in 2013. This difference arises due to the method of calculation of the index).

The 2014 TSX Hounds underperformed the broader indices by a huge margin, as energy stocks were decimated in the fourth quarter of the year. The Hounds generated total returns on average of -12.39% (Table 3), compared with 12.27% for the TSX-60 and 10.55% for the TSX Composite. (In 2013, the Hounds had outperformed, with total returns of 19.87%, compared with 13.26% for the TSX-60 and 12.98% for the TSX Composite. In 2012, the Hounds had underperformed, with total returns of only 0.1% compared with 8.1% for the TSX-60 and 7.2% for the TSX Composite).

As was the case in 2012 and 2013, the 2014 TSX Hounds had much greater variability in their returns than the Dow Dogs, as noted below:

- Six of the 2014 Hounds had negative returns for the year, including all five of the 2014 Hounds from the energy sector. Only three of the 2014 Dogs had negative returns for the year, and two of these had negative returns of less than 1%.
- Penn West was the worst performer among the 2014 Hounds, as it plunged more than 70%, after ranking among the worst two performers in 2012 and 2013.
- Enerplus continued its rollercoaster performance, plummeting 42% for the third-worst performance among the 2014 Hounds; it had rebounded 50% in 2013 after plunging 50% in 2012.
- **The best performer of the 2014 Dogs was Intel, with total returns of 44.3%. The best performer of the 2014 Hounds was Fortis, with total returns of 33.1%. Both Intel and Fortis have been constituents of our Model Portfolio since its inception in March 2014.**
- In terms of sector performance, technology stalwarts Intel and Cisco were the top two performers of the 2014 Dogs. Bank of Montreal and CIBC ranked third and fourth for performance among the 2014 Hounds.

Note the following points with regard to the 2015 Dogs and Hounds:

- There are three new entrants among the 2015 Dogs (Table 4), with the three best performers of 2014 – **Intel, Cisco, and Johnson & Johnson** – replaced by **General Electric, Exxon Mobil, and Coca-Cola**.
- There are as many as five new entrants among the 2015 TSX Hounds (Table 5), with **Teck Resources, Arc Resources, Cenovus Energy, Husky Energy and Pembina Pipeline**, replacing **Penn West, Enerplus, EnCana, Fortis and BMO**.
- The 2015 Dogs are more diversified than the 2015 Hounds, with two stocks each from telecom, energy, pharmaceuticals, and consumer staples, plus one each from the industrial and consumer discretionary sectors. The 2015 TSX Hounds continue to be dominated by energy, with five stocks from the sector for the third successive year.
- **As was the case last year, dividend quality of the Dogs continues to be much better than that of the Hounds.** All 10 of the 2014 Dogs boosted their dividends last year. The three new entrants in the 2015 Dogs – GE, Exxon and Coca-Cola – also raised dividends last year.
- The 2014 Hounds with the highest dividends at the beginning of last year – Penn West, TransAlta, and Canadian Oil Sands – slashed dividends in 2014. The four 2014 Hounds who hiked dividends last year – BCE, Bank of Montreal, CIBC, and Fortis – had also done so in 2013. **Of the five newcomers in the 2015 Hounds, only Cenovus and Pembina Pipeline raised dividends in 2014.**
- **Valuations for the Dow Dogs have risen over the past year.** The 2015 Dow Dogs are trading at an average forward P/E (based on 2015 forecast EPS) of 15.9 (Table 4), compared with 13.9 a year ago. Average earnings growth for 2015 is also forecast to decline 2% (largely due to significant earnings drops at Chevron and Exxon), compared with growth of 6.7% a year ago. However, the average 3.55% dividend yield for the 2015 Dow Dogs is up from 3.41% for the 2014 Dogs.
- **Valuations for the 2015 TSX Hounds have also deteriorated, largely due to forecast declines in earnings for energy producers.** The average forward P/E is 27.6, compared with 25.5 a year ago, and average dividend yield has declined from to 5.69% from 6.25% a year ago. Note that the dividend yield shown for the 2015 TSX Hounds is the indicated yield, based on the last dividend payment.
- Investors looking for high dividend stocks ex-energy could consider **Verizon, GE and McDonald's** among the 2015 Dogs, and **BCE and Pembina** among the 2015 Hounds, as they offer earnings growth and reasonable valuations. **TransAlta and Teck** look interesting, although 2015 EPS growth forecasts seem optimistic.

- 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, \$15.11), which provides returns equivalent to that of the DJ High-Yield Select 10 Total Return Index (MUTR) mentioned earlier. In 2014, the note generated a return of 10.25%, compared with 10.84% for the MUTR index.

Table 2: 2014 Dogs of the Dow

Stock	Ticker	Sector	Div.Yield (end-2013)	Price chg. 2014	Total ret. 2014
AT&T	T	Telecom	5.12%	-4.47%	0.65%
Verizon	VZ	Telecom	4.22%	-4.80%	-0.56%
Intel	INTC	Technology	3.47%	39.82%	44.30%
Merck	MRK	Pharma	3.44%	13.47%	16.95%
McDonald's	MCD	Consumer Disc.	3.22%	-3.43%	-0.11%
Pfizer	PFE	Pharma	3.07%	1.70%	5.30%
Chevron Corp.	CVX	Energy	3.04%	-10.19%	-6.98%
Cisco Systems	CSCO	Technology	2.90%	24.01%	27.91%
Procter & Gamble	PG	Cons. Staples	2.86%	11.89%	15.42%
Johnson & Johnson	JNJ	Pharma	2.77%	14.17%	17.34%
			3.41%	8.22%	12.02%

Table 3: 2014 Hounds of the TSX-60

Stock	Ticker	Sector	Div.Yield (end-2013)	Price chg. 2014	Total ret. 2014
Penn West Petro	PWT	Energy	12.18%	-72.60%	-69.66%
TransAlta	TA	Utilities	8.62%	-21.96%	-17.29%
Canadian Oil Sands	COS	Energy	7.01%	-47.85%	-44.22%
Crescent Point	CPG	Energy	6.69%	-34.76%	-30.03%
Enerplus	ERF	Energy	6.06%	-42.02%	-38.51%
BCE Inc.	BCE	Telecom	5.03%	15.83%	21.74%
EnCana	ECA	Energy	4.43%	-15.69%	-14.40%
Cdn. Imperial Bank	CM	Financials	4.19%	10.05%	14.62%
Fortis	FTS	Utilities	4.14%	27.95%	33.05%
Bank of Montreal	BMO	Financials	4.12%	16.06%	20.79%
			6.25%	-16.50%	-12.39%

Table 4: 2015 Dogs of the Dow

Stock	Ticker	Sector	Div. Yield (end-2014)	Price (end-2014)	2015 EPS (forecast)	EPS chg. (‘15 vs. ‘14)	Fwd. P/E (‘15 EPS)	Fwd. EV/ EBITDA
AT&T	T	Telecom	5.48%	\$33.59	\$2.58	1.38%	13.0x	5.8x
Verizon	VZ	Telecom	4.57%	\$46.78	\$3.74	8.31%	12.4x	6.4x
Chevron Corp.	CVX	Energy	3.69%	\$112.18	\$7.24	-25.31%	14.9x	5.3x
General Electric	GE	Industrial	3.48%	\$25.27	\$1.76	6.79%	14.0x	8.8x
McDonald's	MCD	Consumer Disc.	3.46%	\$93.70	\$5.45	8.14%	16.9x	10.2x
Pfizer	PFE	Pharma	3.27%	\$31.15	\$2.21	-1.60%	14.1x	9.1x
Merck	MRK	Pharma	3.10%	\$56.79	\$3.52	0.98%	16.5x	10.8x
Exxon Mobil	XOM	Energy	2.86%	\$92.45	\$5.77	-20.98%	15.7x	6.8x
Coca-Cola	KO	Cons. Staples	2.83%	\$42.22	\$2.04	0.20%	20.7x	15.6x
Procter & Gamble	PG	Cons. Staples	2.73%	\$91.09	\$4.31	2.11%	20.9x	13.8x
			3.55%			-2.00%	15.9x	9.3x

Table 5: 2015 Hounds of the TSX-60

Stock	Ticker	Sector	Div. Yield* (end-2014)	Price (end-2014)	2015 EPS (forecast)	EPS chg. (‘15 vs. ‘14)	Fwd. P/E (‘15 EPS)	Fwd. EV/ EBITDA
Crescent Point	CPG	Energy	10.26%	\$26.91	\$0.48	-61.67%	51.5x	6.0x
Canadian Oil Sands	COS	Energy	7.68%	\$10.42	\$0.23	-79.80%	39.3x	7.8x
TransAlta	TA	Utilities	6.84%	\$10.52	\$0.31	50.96%	33.8x	8.0x
Teck Resources	TCK/B	Materials	5.67%	\$15.88	\$1.16	38.52%	13.4x	5.6x
ARC Resources	ARX	Energy	4.77%	\$15.88	\$0.75	-33.98%	31.5x	7.8x
BCE Inc.	BCE	Telecom	4.64%	\$53.28	\$3.31	4.32%	16.0x	7.9x
Cenovus Energy	CVE	Energy	4.44%	\$23.97	\$0.80	-55.11%	29.1x	6.8x
Husky Energy	HSE	Energy	4.36%	\$27.50	\$1.28	-42.67%	20.8x	6.2x
Cdn. Imperial Bank	CM	Financials	4.13%	\$99.84	\$9.31	4.15%	10.6x	n/a
Pembina Pipeline	PPL	Pipelines	4.11%	\$42.34	\$1.36	9.50%	30.3x	15.2x
			5.69%			-16.58%	27.6x	7.9x

*Indicated Dividend Yield

Market Snapshot

At close today

S&P TSX	14392.70	-360.95	Commodities			Yields (%)	Can.	US
TSX Venture	693.99	-12.83	Canadian \$ (US cents)	85.03	+0.17	90 Day T-Bill	0.90	0.01
DJIA	17501.65	-331.34	Gold (Spot)-US\$	1204.82	+15.59	2-Year Bond	0.98	0.66
S&P 500	2020.58	-37.62	Oil (WTI-Feb.)	50.04	-2.65	10-Yr. Bond	1.68	2.03
NASDAQ	4652.57	-74.24	CRB Index	226.73	-1.69	30-Yr. Bond	2.24	2.60

Thought for the Day

“Success isn’t permanent, and failure isn’t fatal.” – Mike Ditka

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