

## TRADING STRATEGY: DOGS OF THE DOW THEORY (DOD)

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### ABSTRACT

One of the difficulties faced by participants (primarily depositors) in the stock market is the goal of yielding a higher return at a lower cost. Past researchers have studied numerous trading techniques and suggested novel strategies in order to overcome this particular obstacle, but the results remain enigmatic. These high evolutions in trading strategies that occurred in the investing environment cover many factors such as fundamental features (company ratios) and economic variables, but the findings were discouraging due to the mixed results published. A variety of factors may be attributed to these circumstances, with one of the most obvious being unpredictability in global economic conditions. Thus, this paper aims to concentrate on the high yielding strategy of Dogs of the Dow Theory as trading strategies under portfolio construction, in which this strategy differs from other high yielding methods. This paper is consist of several parts, including the history of trading strategies and scientific data supporting the Dogs of the Dow Theory as a trading strategy.

### I. INTRODUCTION

Effective trading strategies are characterized as decisions taken by investors to manipulate their investments in order to achieve the goals and objectives of their investing activities (Brown and Reilly, 2009). Trading techniques can help investors in a variety of ways, most notably by allowing them to earn better yields while taking on less risks. Further defined as the actions taken by companies and investors to generate favorable returns across allocated portfolios, effective and dependable trading strategies are also critical and are necessary due to competition among companies in attracting prospective depositors (Ekaputra and Sukarno, 2012). Returns are regarded in the investing world as incentives for investors who take risks, while risks are the chances that real returns will differ from the predicted returns targeted by the investors (Basu and Chawla, 2010). Risks are usually classified into two types: systemic risks and unsystematic risks. However, in relation to trading practices, only systemic risks are perceived attributable to the portfolio's potential to exclude unsystematic risks by diversification policy (Kazi, 2008). William Sharpe (1964) and John Lintner (1965) first stated these ideas through the principle of Capital Asset Pricing Model (CAPM), which has since been generally accepted and practiced by academics. Diversification approach is one of the most successful strategies for reducing investing losses because it prevents investors from throwing all of their eggs in one basket. The reasoning behind this strategy is the portfolio's substance, in which securities from different sectors are pooled together to create a portfolio. As a result, individual risk in each sector could be balanced due to a variety of shares from various industries that could offer higher returns at lower risks (Hoh et al., 2011).

#### Trading Strategy Evolution

Numerous well-known and widely applied investing techniques or philosophies have emerged, with Modern Portfolio Theory being one of the basic theories in portfolio construction (MPT). Proposed by Harry Markowitz in 1952, the principle has since been extended by William Sharpe (1964) and John Lintner (1965), resulting in the implementation of the Capital Asset Pricing Model (CAPM), until being further strengthened solely by Stephen Ross in 1976 as the Arbitrage Pricing Theory (APT). While the concepts behind these three hypotheses differ, they are both relevant to the overall method of portfolio building. Although their efficacy is still being debated among past scholars due to mixed findings published, the prevalence of these theories is definitive because they are still being practised, especially in the academic field (Shamsabadi et al., 2012 and Zhang and Li, 2012). As a result, many new trading techniques have been created to solve the flaws of these three hypotheses, one of which is the high-yielding approach, which will be the focus of this article. Dogs of the Dow Theory (DoD), popularised by Michael O'Higgins and John Downes in 1991, is one of the most well-known high-yielding strategies.

#### Dogs of the Dow Theory (DoD)

The Dow 10 Theory (commonly known as the Dogs of the Dow Theory (DoD)) is a well-known investing technique in the United States (US) that was popularised by Michael O'Higgins and John Downes in their book

'Beating the Dow' in 1991. It aims to outperform the market's results. When building a portfolio, the Dow Jones Industrial Average (DJIA) shares with the highest dividend yield (DY) are chosen, and this portfolio must be rebalanced and revised on a yearly basis. Prior to O'Higgins and Downes' book, analyst John Slatter initiated the investing technique of using high DY shares in 1988 through his article titled 'Study of Industrial Averages Finds Stocks With High Dividend Are Big Winners,' in which he discovered that the 10 highest-yielding shares of the DJIA were able to outperform the DJIA statistically from 1973 to 1988. However, investors only became aware of the DoD hypothesis after reading a book written by O'Higgins and Downes (Qiu et al., 2013 and Tissayakorn et al., 2013).

The word "Dogs" in the DoD applies to losers and the ten highest yielding shares imply the lower values that such shares actually have (Tissayakorn et al., 2013). In fact, one of the conditions of the DY strategy is that earnings can fall when dividends can rise, since investors are more concerned with earnings. It means that demand for respective shares will decrease if earnings posted by those firms fall, which will further lower share prices (O'Higgins and Downes, 2000) because earnings are one of the key drivers of dividend level (Andersson et al., 2010). Furthermore, dividends reflect the true worth of the stock, and hence DoD theory is a method of building a portfolio comprised of undervalued or out-of-favor securities that are expected to accelerate while the market is in a favorable position (Ekaputra and Sukarno, 2012).

In particular, O'Higgins and Downes (2000) argued that DoD theory consists of many distinct parameters, as opposed to traditional high-yielding strategies. To begin, the securities in the DoD portfolio were chosen based on the market's blue chip shares, which reflect the key sector and economic situation of that particular nation. This is significant because it reflects the general image of business success, and any concentrated risks held by particular industries can be excluded (Rowlett, 2012). Thus, the shares concerned are typically those of the largest and most powerful firms, where it represents the most liquid and well-known companies with long-term success, considerable wealth, and an outstanding reputation (Jeong et al., 2008). Nonetheless, Damodaran (2004) said that investing in both matured and young firms would help investors in various ways, and the best explanation is that companies with less followers (young companies) seem to be mispriced, and there is often a lack or no interest from institutional investors at the early stage. In this scenario, young firms will be able to draw more new investors (both individual and institutional) as they develop, which will favour current shareholders. The most intriguing aspect is that current shareholders which expect a higher payout during the growth cycles of those respective companies. A study undertaken in the United States by Banz (1981) demonstrated that restricted diversification triggered by a lack of knowledge about small businesses could offer a substantial abnormal return to shareholders.

Second, DoD is known as a short-term investing approach due to the condition that DoD portfolios be rebalanced and revised on a yearly basis. According to O'Higgins and Downes (2000), the key challenge in long-term strategy is liquidity, which means that if investors require funds, they can be forced to sell the best shares (best performers) they own or suffer losses by selling the underperforming shares. Then, if investors want to invest in the long term, they will have to forego the possibility of substituting the new best shares. However, Damodaran (2004) stated that, as opposed to the short-term cycle, shares are less risky in the long-term horizon since a bad year can be offset by a good year /

Finally, the original formulation of DoD theory contains ten shares of each portfolio, and O'Higgins and Downes (2000) confirmed that DoD is a straightforward theory due to the same approach used in portfolio construction. Because of the large number of shares involved, it is well suited to cautious investors. As a result of its flexibility and applicability in comparison to other methods, this theory may be implemented by both institutional and individual investors (Ekaputra and Sukarno, 2012). In contrast to this argument, Damodaran (2004) claimed that the return of a portfolio consisting of just ten shares may be misleading because there are thousands of shares available in the capital market and, typically, the Dow dogs are much riskier than the other shares where the higher return earned was attributed to the higher risk. He also said that the requirements of high dividend shares are acceptable for risk-averse investors, while the definition of loser shares under DoD is appropriate for risk-seeking investors. The explanation for this is due to the companies' tradition of offering exciting prospects to customers willing to take risks only after the firm has performed poorly in the past. DoD theory is classified as a contrarian approach since one of the key contrarian indicators is high DY. It demonstrates that investors are concerned about the company's potential profits because a high yield is

correlated with lower share prices (O'Higgins and Downes, 2000). Companies are at the bottom of the business cycle if their securities have a lower stock valuation thanks to high DY, and those rates are expected to rise higher than low yield shares, benefiting investors more (Ekaputra and Sukarno, 2012). This is analogous to the study conducted by Andersson et al., (2010), who stated that, in addition to a lower beta, high yielding shares normally have a higher alpha, which suggests that such shares appear to have a higher return than indicated by their level of risk. On the negative side of this contrarian approach, Damodaran (2004) argued that contrarian investors appear to depend more on their intuition in making judgments pertaining to share market movement, where this sort of investor uses two basic arguments. First and foremost, 'it is still darkest before sunrise,' which means that the safest time to buy the shares is when negative news has forced down the price so the chance of the market price rallying is better in the negotiating process. The second point is that 'lower-priced shares are cheaper,' where shares that have dropped significantly in price are frequently sold at a lower price, and there are buyers who believe that lower-priced shares are cheaper and more appealing owing to a bargain opportunity, despite the risk that stocks will fall dramatically over the same time. Aside from the contrarian label, DoD theory is also regarded as a value investing approach due to its high-yielding securities. According to Visscher and Filbeck (2003), value shares have high DY but low price-to-book ratios, price-to-earnings ratios, and expected growth rate, while growth shares have low DY but high price-to-book ratios, price-to-earnings ratios, and expected growth rate. The reasoning behind this situation is that investors often overreact negatively to negative company financial news (resulting in downward stock price movement) and favourably to favourable company financial news (resulting in upward market price movement). In this case, the previous overreaction will result in valuation shares, while the latter will result in growth shares.

There are several distinctions between value and development investors, but the most significant distinction is in their adherence to the Efficient Market Hypothesis (EMH). Quality investors are opposed to the EMH hypothesis and they depend on their own judgement up to the point that they believe the securities are overpriced. Generally, signs of underpriced shares are a good buy signal, while indications of overpriced shares are a good sell signal. They saw this as a gain because they are investing in the depressed securities by substituting them from struggling businesses. This will continue to raise equity values even further, and they will sell them until they are comfortable with the current price range. According to Hoh et al. (2011), this category of investor is classified as an aggressive investor who employs an active approach in the construction of their portfolios. Development investors, on the other hand, follow the same EMH flow and believe that current market rates are fair because they represent all publicly known facts about the firm. Here, growth investors actually appreciate the benefits that are now open to them. As a result, since they use a passive approach in portfolio construction, this category of investors is known as passive investors

. In general, investing in and building portfolios comprised of high-yielding stocks is likely to support investors in a variety of ways (Henne et al., 2009). It is primarily linked to steady positive returns in volatile markets (Henne et al., 2009), since one of the goals of a high yielding approach is to shield investors from downside losses by securing that big return (Franken, 2012). This was reinforced by Alenius (2011) and Safari (2009), who discovered that the DoD approach could shield investors from downside risks in Finland and Malaysia, respectively, because the DoD portfolio outperformed the market in both bull and bear markets. Furthermore, Barron (2001) discovered that during the Canadian market crisis, a high yield portfolio might serve as an inflation buffer because its valuation was increasing, and this portfolio was less risky despite the market's poor state. Next, managing investment challenges may be one of the reasons why investors seek high dividend income (Dong et al., 2005), since dividends are received from actual earnings, where dubious financial reporting activities can be prevented (Tripathi and Aggarwal, 2012). In reality, there are managers who are incompetent in handling cash as a result of weak investment prospects; therefore, a high dividend announced could help to contain this issue (Damodaran, 2004). Declaring a high dividend on behalf of the firms is often a smart option, especially in countries such as Malaysia that levy corporate tax on retained pre-tax earnings, whereby declaring a high dividend obviously reduces the tax burden of the companies (Foong et al., 2007). The following section discusses the actions of investors who saw dividends as a signal of a company's success (financial stability). Essentially, DY is rather insightful (Montgomery, 2013) because lowering or slashing the dividend is a pessimistic indicator indicating that the firms are experiencing substantial and long-term financial difficulties (Karpavicius, 2014 and Damodaran, 2004). Karpavicius (2014) discovered that firms seek to

preserve their dividend amount in order to increase their share values, even though the companies do not want to use the announced dividend as a signal system for investors. This is because the smoothness with which dividends are paid is positively linked to the movement of share prices as well as the efficacy of the firms' projected success. Furthermore, higher share prices will contribute to increased investor confidence, which will positively impact both investor demand and company growth at the same time (Montgomery, 2013). This condition occurs in Thailand's emerging market, where Jiranyakul (2011) found that investors value dividend payments above capital gains because dividend returns are greater in size and more strongly important in the risk-return relationship.

Investing in high-yielding stocks has many pitfalls, one of which being the failure to value firms that do not pay dividends to their shareholders and dividend cuts or declarations may occur in both large and small businesses (Montgomery, 2013). According to Ghosh (2010), larger firms in India still pay more dividends, yet they are often the ones that prefer to slash dividends when they have issues. Then, high DY does not warn investors of the amount of potential return from capital gains, and investors are responsible for estimating the intrinsic value of the shares. This is important because buyers will determine whether the share exchanged is cheaper or more costly than the market price. Finally, since it is influenced by many uncontrollable causes, highDY does not represent the economic return that investors might receive from buying a share (Montgomery, 2013). Applying DoD strategy is commonly accomplished by two main methods, which result in two major effects, namely statistical impact (considering no threats, taxation, or processing costs) and economically effect (considering either risks, taxes or transaction costs).

Historically, O'Higgins and Downes (1991) performed the first study directly for DoD with respect to DJIA, with the findings indicating that the DoD portfolio was statistically able to outperform the economy. McQueen, Shields, and Thorley published the first academic study in 1997. (Qiu et al., 2013). McQueen et al. (1997) discovered that the Dow 10 outperformed the DJIA statistically over the first 30 years of the study, from 1946 to 1995. However, when liability and acquisition costs, as well as taxes, were factored in, the Dow 10 underperformed the DJIA, demonstrating that the Dow 10 could not outperform the DJIA economically. The causes are data mining and the lack of an industry anomaly. The findings of McQueen et al. (1997) were followed by Hirschey (2000), who discovered that abnormal losses were reported after transaction costs and taxes were taken into account, and he believed that this technique was inefficient due to data errors discovered by O'Higgins and Downes (1991) during their research. Because of this complication, Prather and Webb (2002) agreed to perform an analysis close to that of O'Higgins and Downes (1991) in order to classify if Hirschey's assertion of a data error was correct (2000). As a result, they discovered that there was a business anomaly that allowed an abnormal return to be produced and that data error was not the cause. Factors that contribute to this strategy's superior success Following such debates among previous academics, a group of researchers attempted to assess the applicability of DoD policy in various share markets around the world. Rowlett (2012), as well as Ekaputra and Sukarno (2012), published recent studies based exclusively on predictive results, and discovered that DoD portfolios outperformed the market statistically in Thailand and Indonesia, respectively. Then, surveys in Hong Kong by Mingyue, Hong, and Yu (2012), Australia by Alles and Sheng (2008), and the United States by Clavenger and Baker (2004), as well as Prather and Webb (2002), found that DoD portfolios outperformed the market statistically. Nonetheless, there are scholars who use this technique, but the results are contingent on factors such as the time horizon for keeping DoD portfolios. In fact, despite research, In addition to research conducted in the United States by O'Higgins and Downes, research conducted in China by Wang et al., (2011) discovered that an irregular return could be produced in a shorter holding time. in contrast, Clemens (2013), Qiu et al., (2013), Tissayakorn et al., (2013), Alenius (2011), Kazi (2008), and Clavenger and Baker (2004) all reported that the DoD portfolio could outperform the market. And in the long run did the market produce a higher abnormal return.

There were also reports that focused on the efficacy of DoD tactics in various market conditions (bull and bear market). Essentially, the DoD approach should be capable of protecting investors from downside risk; but, contrary to this assertion, Broberg and Lindh (2012) and Sahu (2001) stated that this strategy was successful only in rising market conditions (bullish market). Finally, Domian et al. (1998) published an analysis comparing the success of high-yield and low-yield portfolios in the United States during the pre-crash (1964-1986) and post-crash (1989-1997) periods. They discovered that both portfolios showed mixed outcomes and those

portfolios registered positive and bad results separately during the time, but the most notable point was that the high-yield portfolio was only able to outperform the market for a few months.

In both previous periods, it underperformed the market entirely. Thus, the researchers concluded that the DoD strategy was ineffective in the United States, and the key explanation given was the absence of business anomaly. Since this technique was successful and broadly adopted.

The following section discusses the application of a more advanced approach (statistically and economically effect) in which several researchers replicated this technique that included both existing and emerging markets. Unlike the findings of McQueen et al. (1997), more recent researchers discovered that the DoD technique was important in both statistical and economic terms. Latest studies in emerging markets undertaken by Yan et al., (2015), Safari (2009), and Wolmarans (2004) found that DoD portfolios outperformed the industry statistically and economically in Taiwan, Malaysia, and South Africa, respectively. Parallel findings in emerging economies have been published by Qiu et al. (2013), Andersson et al. (2010), Brzeszczynski et al. (2008), Lemmon and Nguyen (2008), Brzeszczynski and Gadjka (2008, 2007), and Visscher and Filbeck (2003). Both of the analysts found that the DoD portfolio outperformed the market statistically and economically in Japan, Sweden, the United Kingdom, Hong Kong, Poland, and Canada, respectively.

In comparison to the preceding findings, a number of researchers discovered negligible results between DoD strategy and irregular return when risk, taxation, transaction costs, or commissions were factored in. For example, a Turkish analysis concluded that the DoD portfolio underperformed the market in both statistical although economic terms, and they find no indication that this DoD strategy was less costly than the buy and hold strategy (Prather et al., 2011). According to Dahlstedt and Engellau (2006), who conducted an analysis in the Nordic Stock Market, the DoD policy underperformed the sector in both statistical and economic terms, as high DY was clarified in that market by a decrease in stock prices rather than an increase in dividend paid. Following that, Henne et al., (2009) discovered an irrelevant association between DoD policy and irregular return in the German stock market. However, high-yield shares will reduce the risk of buying, but their impact diminishes significantly as the degree of diversification increases. Finally, Leal et al., (2000), who conducted a study of DoD policy in relation to established markets in the United States versus emerging markets in Brazil, reported that the findings were very disappointing. This is because the DoD policy was obviously unsuccessful when applied in Brazil, but in the United States, the proof of success was minimal because the DoD was statistically important but not economically. It went on to say that while the DoD strategy will bring value as an investment strategy in the United States, it is not ideal for small investors.

## II. CONCLUSION

Investors want to make money off their savings. Their goal is to get a high return with a low risk. Many trading techniques have been created in an effort to increase investment returns, with CAPM and APT being two of the most common. Actually, DoD is one of the trading techniques that is specifically linked to DY basis on which previous studies have recorded mixed findings pertaining to the effectiveness of DoD however, the highlighted point is that outcomes published with respect to particular developed and emerging markets differ. As a result of these circumstances, arguing that this DoD is only useful in developing or emerging markets is fictitious. This paper aims to introduce and recognise the presence of this easy but appealing trading technique, which has been around for more than two decades but is barely used by investors.

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