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Selectively breeding the Dogs of the Footsie

"Dogs of the Dow" sounds like one of those high finance/high drama hybrid films Hollywood is making (occasionally) these days.

It is, in fact, a famous mechanical investment strategy popularised by Michael Higgins in his book, "Beating the Dow".

The "Dow" in question is the ancient US stock market index, the Dow Jones Industrial Average.

Being so ancient, its characteristics are a bit different to more modern indices, and the two main differences are:

- It only has 30 constituents
- Those constituents are picked to represent a broad spectrum of the stock market, rather than merely being the 30 most valuable companies (in terms of market capitalisation) on the day the constituent list was determined.

As for it being a "mechanical" investment strategy, the term merely means that the sytem uses prescribed selection criteria, with no place for a "human override" option.

So, if the selection criteria indicates that the portfolio should consist entirely of the following companies, you just have to accept it: About To Go Bust Inc; The Bosses Are All Crooks Corp; The Bogus Investment Company; Ponzi, Fonzi & Bozo; and Who Needs Honest Accountants Anyway Inc.

So what are the selection criteria?
They are quite simple.

On a given date - say, January 1 when you are massively hungover and not really in the mood for fundamental analysis of shares - simply look at the 30 constituents of the Dow Jones and pick the 10 that have the highest dividend yield.

Invest an equal amount in each share.

A year later, sell the lot, and pick another 10 (using the same method), investing the proceeds from the 10 stocks you just sold (plus retained dividends) equally among the new 10.

Of course, if the new 10 stocks include some of the old 10, you can save yourself a bit of commission by not selling the retained stocks, and simply topping up or trimming your holding to ensure the amount invested is still the same for each stock.

While it is worth noting that it is not a fool-proof investment strategy, it has proved successful enough to encourage UK investors to try a similar approach over here.

Only problem is, we do not have the Dow Jones index or anything like it.

Except we do.

It is called the FT 30 and dates back to 1935.

You can find the constituents, appropriately enough, on the Financial Times web site.

The benefit of using the FT 30 rather than, say, the FTSE All Share or the FTSE 100, for a mechanical investment strategy is that the constituents tend to stay the same, year in, year out, whereas the FTSE 100 changes every three months.

So, with the FT 30, you get old war horses in there like GKN, which has probably been there since the very beginning, when it was known as Guest, Keen, Nettlefold & Sankey.

The disadvantage with using the FT 30 for an investment strategy, at least from a journalistic point of view, is that no one under the age of 55 knows WTF you are talking about.

(I'm hoping no one over the age of 55 knows what the flip "WTF" means).

So, if we are going to run a UK counterpart of the "Dogs of the Dow" -and by now I hope you have realised that is what this article is all about - then we are going to use the better known FTSE 100 rather than the FT 30.

Feel free to run your own version of the screen using the FT 30 constituents and let us know how you get on.

The Flops of the Footsie
Why was the original US strategy called the "Dogs of the Dow" when the portfolio is comprised of the stocks that give you the biggest bang for your buck in terms of dividends.

Aren't dividends good things?

Yes, indeedy, they are, but you calculate a dividend yield by dividing the divi by the share price (and then multiplying by a 100); with a stock that has a high dividend yield there is usually nothing wrong with the dividend (other than the implicit indication that the market thinks a dividend cut is on the way) - it's the low share price that creates the high yield.

Hence, the "Dogs of the Dow", a nicely alliterative title.

"Dogs of the Footsie" is not so alliterative, but at least people would recognise it as a variant of its better known transatlantic cousin; we were going to call it "Flops of the Footsie" but after browsing the picture library thought better of it.

Changing the secret sauce
Now, we mentioned above that an extravagantly high dividend yield is usually a signal that the City is expecting the dividend to be cut or even binned altogether.

In fact, seeing as the dividend yield is based on what the company paid last year, there is even the possibility that a company with a seemingly high yield has already announced a dividend cut is on its way.

So, given that there are broker forecasts out there for the current year's dividends, it makes sense to use **"forecast dividend yield"** rather than historical dividend yield when selecting the stocks.

Does that mean it is no longer a mechanical strategy?

No, because the selections are still made by means of fixed criteria - only one of those criteria is different from what's usually used in a "dogs" strategy.

While we're fiddling around with the criteria, why not try to mechanically winnow out those stocks that can barely - if at all - cover their dividend payments with their earnings?

For all I know, this might fatally sour the "secret sauce" of the strategy but it makes sense from an old school fundamental investment basis.

My suspicion is that trying to eliminate "flaky" stocks will result in the strategy missing out on some zingers, but maybe also missing out on some donkeys.

So, as our final filter in our Dogs of the Footsie screen, let's limit it to stocks where the **dividend is covered at least 1.5 times** by forecast earnings.

What does that give us?

Company	**Forecast yield**	**Forecast cover**	**(Historical) free cash flow divi cover**
Barratt Developments (LON:BDEV)	7.6%	1.5	3.7
Taylor Wimpey (LON:TW.)	6.6%	1.6	7.3
Capita (LON:CPI)	6.3%	2.0	1.4
Legal & General (LON:LGEN)	6.0%	1.5	5.6
Persimmon (LON:PSN)	5.7%	1.8	1.4
Royal Mail (LON:RMG)	5.6%		

1.9

1.3

TUI AG (LON:TUI)

5.5%

1.6

2.3

AstraZeneca (LON:AZN)

5.5%

1.5

0.2

Marks & Spencer (LON:MKS)

5.5%

1.6

1.8

BT Group (LON:BT.A)

5.0%

1.9

1.8

For interest sake, I have included something called the free cash flow dividend cover as well.

Free cash flow is defined as cash flow from operations minus capital expenditure. Ideally, we want our dividends to be paid out of cash generated, not from money borrowed from the bank or bond markets.

Fortunately, all but Astra seem to have generated enough cash flow last year to cover their dividend commitments. It will be interesting to see whether Astra's skimpy free cash flow cover makes any difference to its share price performance.

The virtual portfolio started on 1 February, 2017. See here for the prices at which the stocks were (virtually) bought.

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