

# Monthly Barometers, Investing in Dow Stocks

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## Overview

- Does “January Barometer” work for other months?
- Investing in Dow Stocks
  - Older “classic” books
  - More recent books/ideas
  - “Dow Turnarounds”

• **NO RECOMMENDATIONS HERE**

Notes on the notes:

1) They were intended to provide reminders for the speaker and not designed to be a complete version of the talk. Between the notes and the slides, you should be able to get a pretty good idea about what was presented.

2) The slides should be readable in this version, but the charts may not be. You can download the slides only file, which should show up much larger on your screen or print at full page size. Download that file at my web site “[www.pankin.com](http://www.pankin.com)”.

3) Talk was given April 3, 2004 at the main branch of the Arlington, Va. Public library as part of its weekly “Stock Talk” presentation.

Since individual circumstances are different, **NOTHING SHOWN HERE SHOULD BE CONSIDERED AS ANY TYPE OF RECOMMENDATION!**

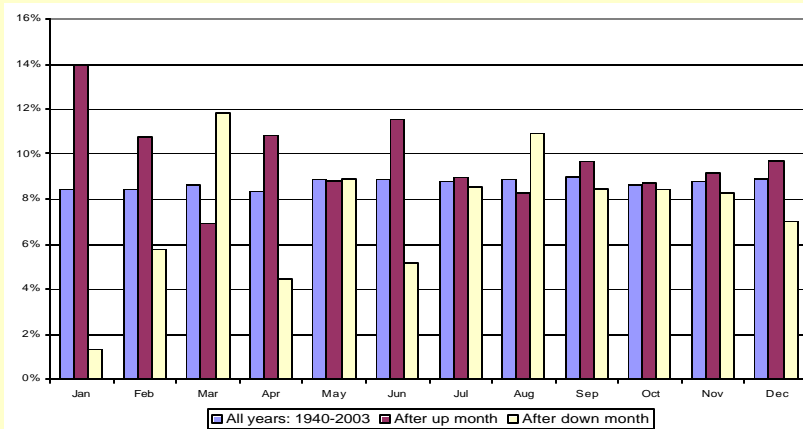
## January Barometer

- “As January goes, so goes the year”
  - After up January, gains are more likely and have higher average
  - Following 3, 6, 11, 12 months
- Test following 12 months for all months based on month's direction
- Data: monthly S&P 500 1940-2003

I discussed the January Barometer in my last talk at the end of January (slides are not available for downloading). It showed that when January is up, it is a good sign for stocks over the following periods, especially the longer ones. Expected returns were higher than after down Januarys and the proportion of up periods was greater.

That raises the question of whether other months are also effective at predicting the following 12 months.

## Average Returns for Next 12 Months



Blue (left) bars are for all years (63 or 64 depending on month); red (middle) bars are for the years after the month was up, and yellow (right) bars are for years after down months.

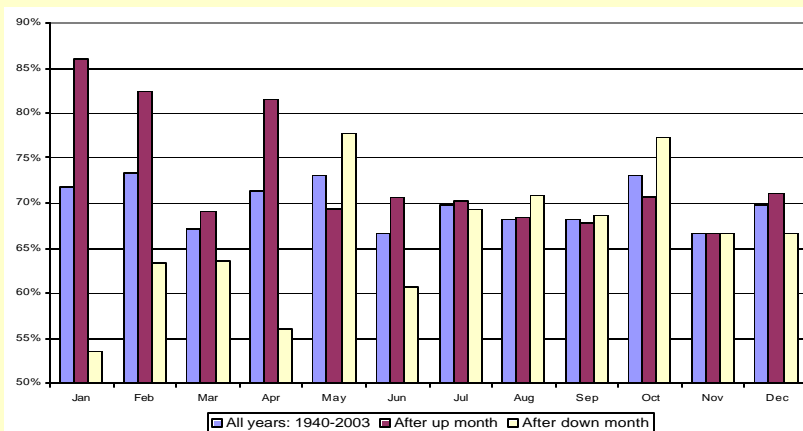
Worth noting:

- \* Blue bars are about the same height, which is to be expected since they are all similar snapshots of the market's overall performance (S&P 500 changes)

- \* January clearly has the largest effect when up

A later graph will show the differences between after up months and after down months, so we can compare the effects of each month

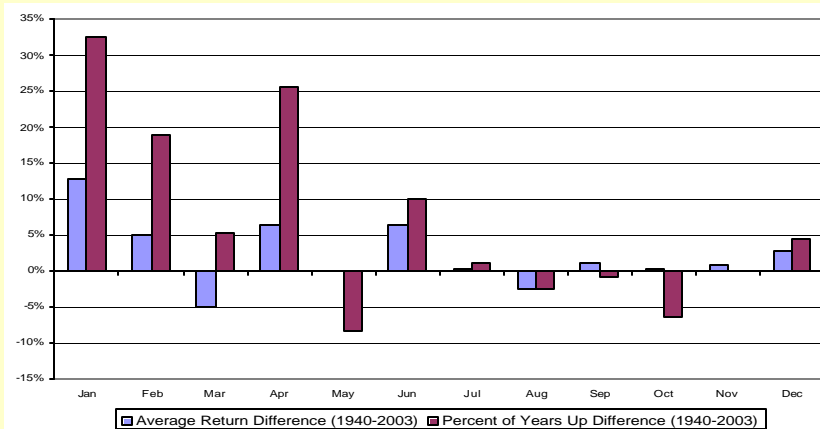
## Percent of Times Next 12 Months Up



Again January has the largest difference.

Note that the lowest point is 50%, so over a long period of time, any month has a probability of better than 50% of rising in the next 12 months.

## Next 12 Months: after up - after down

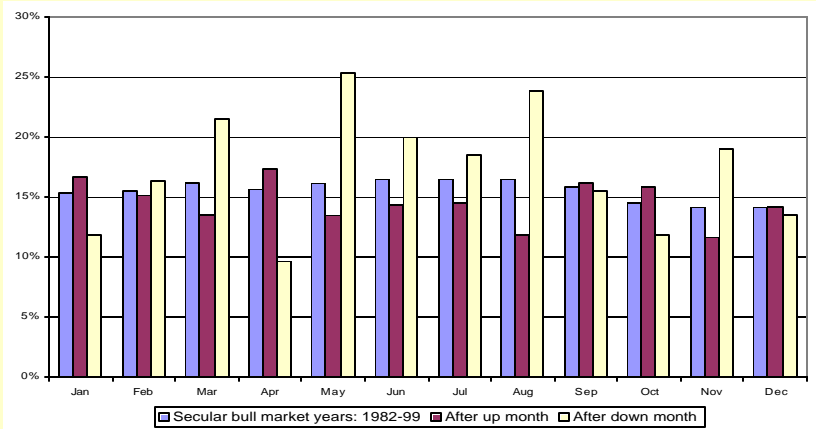


Blue (left) bars are for the differences in average return, red (right) bars are for the differences in percent of months up.

January shows the largest differences, followed by April, Feb., June.

August has a reverse or “inverse” effect in that the following 12 months do better after down Augusts than up ones. To a lesser extent, this is also the case for May and Oct.

## Avg. For Next 12: Secular Bull

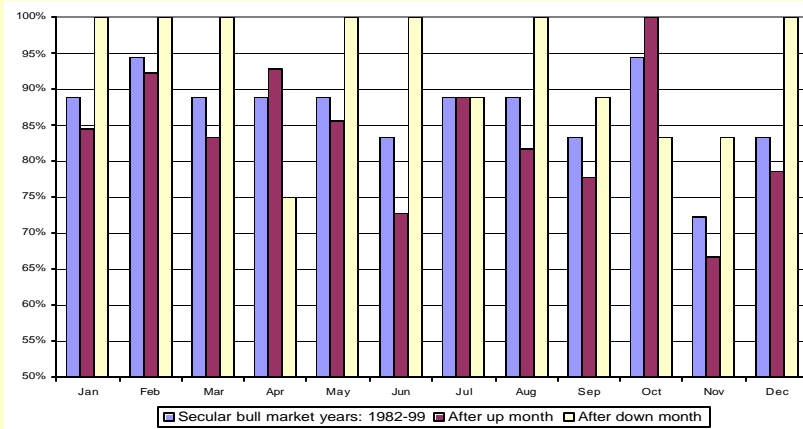


Now we see the same three charts for the last secular bull market, which by whole years was 1982-99, a total of 18 years.

Some of the results for after down months may be misleading due to small numbers (as few as 4) of such months.

Note strong averages in all cases. The lowest bar (after down Aprils) is just under 10%. That shows during a secular bull, it is probably a good idea not to worry about when or if the own stocks. Instead, invest when funds are available.

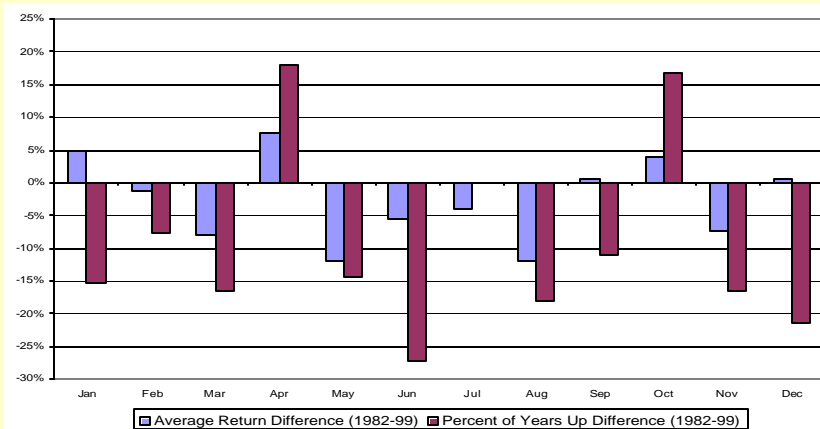
## Percent of Next 12 Up: Secular Bull



Note lowest bar (after up November) is about 67%, showing strength of a secular bull market--over 2/3 chance next 12 months will show gains.



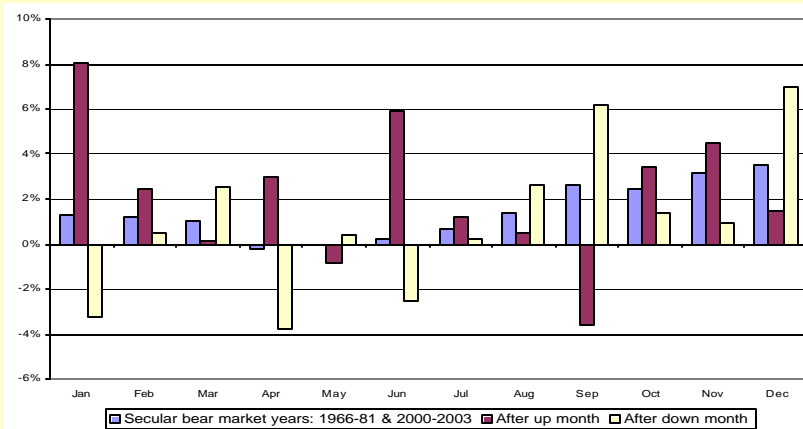
## Next 12: Up - Down in Secular Bull



Here, April and October are best, but January is good for average returns. Many of these differences may be distorted by small numbers, especially of down months. As previous slides show, should not pay too much attention to these differences during a secular bull market.

Next we look at secular bear periods --

## Avg. For Next 12: Secular Bear

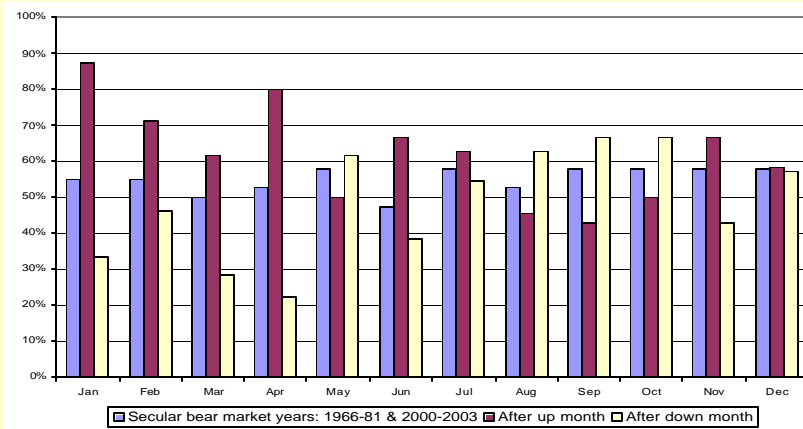


Shows data for 1966-81, and 2000-03, the last full and current secular bear periods.

Note values are lower and some are negative. January is particularly interesting due to large difference and negative average after down months. Similar, but less dramatic for April and June.

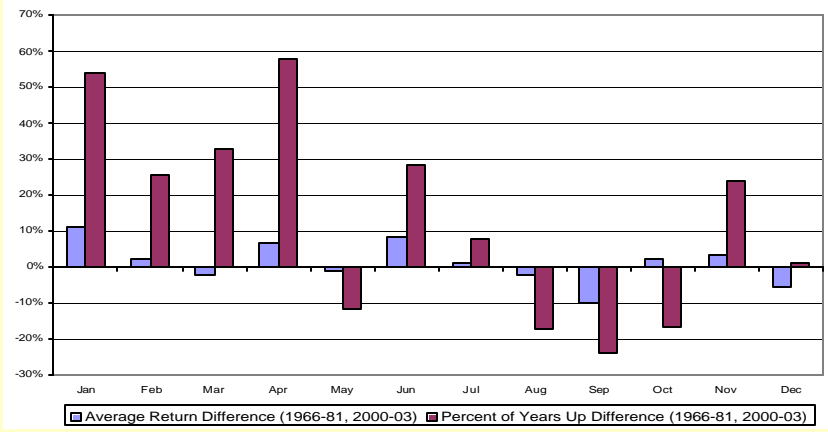
September is a striking "inverse" Note bad Octobers in 1987, 1989, 1998 were during secular bull market and do not affect this chart. However, such are diluted over 12 months, and effect all months.

## Percent of Next 12 Up: Secular Bear



Note lower percentages than before. Many bars below 50% and worst is just above 20% (after down Aprils). Small numbers of cases still can have an effect.

# Next 12: Up - Down in Secular Bear



Similarities (Jan. April, June) to prior cases

## “Barometers”: Following 12 Months

- January, April are best
  - “Work” overall, in both bull and bear
  - February, June also good, but do not work in secular bull market
  - May be few cases in secular periods
- May, Aug., (Sept.): “inverse” barometers: do the opposite after
- During secular bull, better to ignore
- None are “statistically significant”

Lack of statistical significance is due to wide variation in returns. Does not mean that we should not pay attention to these effects, just that we can't be sure they are not due to chance fluctuations alone.

## How Can We Use This?

- Might decide whether or not to invest stocks after each January (IRA contributions) or April (tax refunds)
- During a secular bull market, better to just invest when funds available
- Use with other indicators, models
- How about deciding for the next month based on the prior month?

Tough question.

Basic method would be to make a decision at the end of each January whether to be in or out of the market for the next 12 months. Most would find it hard to stick with that after it did not work for a couple of years. Could also use the January (or other months) to provide guidance: look for other indicators to determine when to get or stay in after up January, to sell or stay out after down Januarys.

Maybe doing this a month at a time would work better, and it would be more practical and easier to stick to. Will not show all the graphs again, but patterns are similar although less dramatic and statistically significant to for next 12 months.

## Predicting the next month

- Similar to, weaker than next 12
  - January, June are best
  - Sept. is best “inverse” indicator, likely due to a few October “crashes”
  - Not statistically meaningful
- Trading by last month’s up/down
  - Improves a bit with Sept. inverse
  - Better than buy & hold, especially during secular bear periods
  - Not as good as Triple-40 model

Trading based on direction of previous month is better than buy and hold, and it improves a bit if one does the opposite of September. However, the latter may be due to a few bad Octobers, so I am skeptical about it.

No details shown because in either case, it not as good, especially from a risk reduction standpoint, as the Triple-40 model (next slide) that I have discussed in past talks.

## Triple 40 Timing Model

- Weekly (Friday data) calculations:
  - 40 week moving average of S&P 500
  - 40 week MA of 90-day T-Bill rate
  - 40 week MA of 10-year T-Bond rate
- Model signals (comparisons to MAs):
  - Buy if S&P is above its MA and at least one T-rate is below its MA
  - Sell if S&P is below its MA or both T-rates are above their MAs

Logic: want to be in market when stocks are trending higher and interest rates are at least somewhat favorable (trending lower).

Note sell signal is logical inverse of buy signal

Model developed by Mark Boucher and discussed in Nelson Freeburg's *Formula Research* issue of 12/17/02. Freeburg does not know when the models were developed by said they had been around for several years. Not clear when out of sample period begins, but model is simple, so likely to be fairly robust.

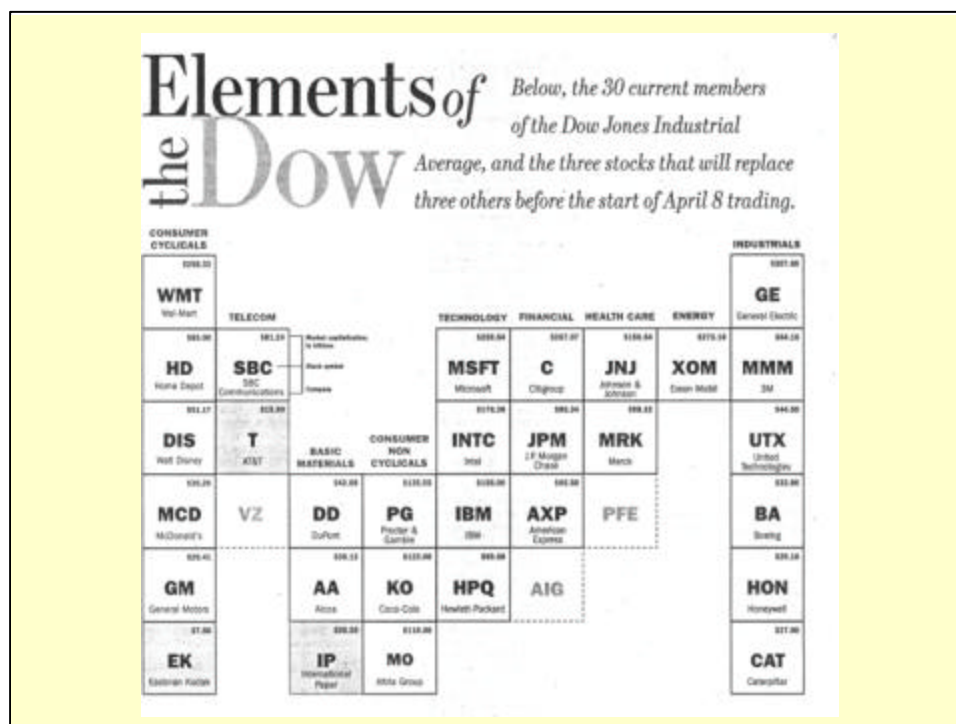


## Why to Invest in “Dow” Stocks

- Industry leaders, broad spectrum of household names
- Virtually certain to be around in five years unless bought out or merged
- Comparable non-Dow stocks, but *Wall Street Journal* publishers have done much of the spadework

Appropriate for more conservative investors since these are companies that do not figure to go down the tubes quickly. (Don't know if Enron or Worldcom would have been considered Dow quality or not.)

General approach is to buy these when they have been beaten down and may well be “undervalued” figuring that they will get their acts in order (strong resources, dominant market positions) and the stock prices will recover and do better than the broad market.



Changes, effective on Wed. announced this past week.

Chart in Friday's *Wall Street Journal* shows things in nice perspective as to broad economic sector coverage and changes. Three of four Technology have come in since 1997 (IBM last entered in 1979).

Three stocks leaving (in gray) had the lowest current market capitalizations of the 30 Dow stocks, so it is not surprising that they were removed. Low relative market caps indicates less importance to the overall economy. The three that enter have much larger caps and larger than most of the current Dow stocks.

## Dividend Yield Approaches

- “Classic” books
  - *Beating the Dow*, O’Higgins & Downes (1991)
  - *The Dividend Investor*, Knowles & Petty (1992)
  - *The Motley Fool Investment Guide*, David & Tom Gardner (1996)
  - Web site: [www.dogsofthedow.com](http://www.dogsofthedow.com)
- Problem with yield-based approach: too few now make the top ten
  - Nature of last two changes to Dow
  - Changed corporate attitudes, but new tax law, weak markets may reverse

Knowles & Petty, O’Higgins & Downes about the same time and independent as best I can tell from the books.

K&P advocated buying equal dollar amounts of ten highest yielding at the end of the year. They have data back to 1961. O&D also suggested buying five lowest priced of those ten, the so-called “Dogs of the Dow”.

Motley Fool modified that by saying don’t buy lowest priced and double up instead on second lowest priced (penultimate profit prospect--PPP), to get the Foolish Four. That always seems too contrived to me and “overfitting” the data.

Changes in Dow since 1997 have invalidated yield based approaches to my thinking because only about half the stocks are reasonable candidates. Motley Fool has abandoned its Dow strategies, which it modified a couple of times to try to save them. The modifications still involved dividend yields.

## “Outperform the Dow”

- Book in 2000 by Meissner & Folsom
- Own **best 5** Dow performers over last year for the next year
  - Does not test well over 1971-2003, does worse than Dow, S&P
  - Very poor 2000-03, after book written!
  - Books tests July-June “years” for 1973-98, which does better
  - I don’t have monthly data that far back

Found this book in Strand Books in NY at about 1/3 of its \$40 list price. I think it is still in print and can be found on-line. Library does not have it.

Getting monthly data for Dow stock back into history is a problem. Either type in from S&P stock price books (in library) or pay S&P a lot of money for computer files.

## “Outperform the Dow” (2)

- “Smooth Risers” strategy
  - 10 best of Dow over last 12 months
  - Buy 5 least volatile, hold for next year
  - Volatility = Std. Dev. of last 12 months
  - Does not test as well in book as buying best five performers
- Many other approaches, including using futures, options
- Interesting, not highly recommended

Due to lack of monthly data I did not test the smooth risers approach, but since the five best performers approach did not do well in my testing, I am not optimistic about the smooth risers.

This book would be of interest mainly to those who focus on methods of investing in the Dow stocks. I would rate it below all of the other books mentioned in the talk.

## “Winning with the Dow’s Losers”

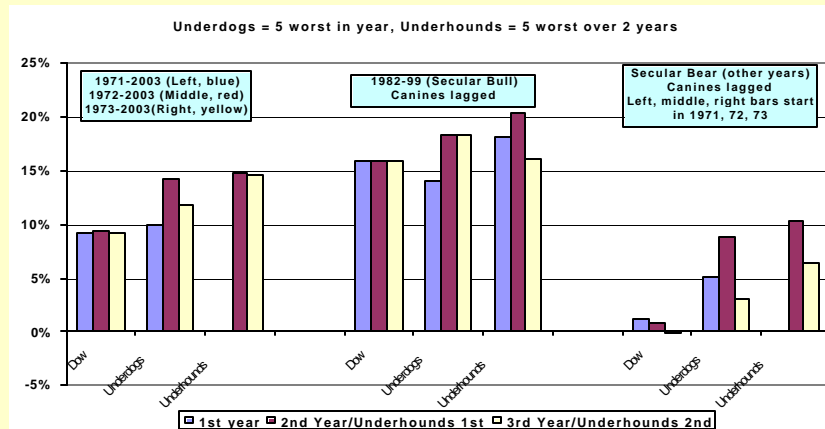
- Book in 2004 by Charles Carlson
- Own some of worst Dow performers over last year for the next year
  - Book shows 1, 3, 5, 10 since 1931
  - I tested 5 for 1971-2003
  - First year performance not impressive
  - Much better in second, third years
  - Worst 5 over past two years also perform well over next year, two years

This is an excellent book by a long-time Dow student and “expert”

I found, like the Dogs, the second year is often better than the first. That may be due the undervalued Dow components needing more time to really turnaround.

Some of my Dogs research is on my web site.

## Average Annual Price Changes



Complex graph that needs to be explained in detail. Take enough time.

Left three groups are for 1971-2003, 1972-2003, 1973-2003 by Dow, Underdogs, Underhounds (longer underdogs!). Since my data start with 1970, that year is needed for ranking, so can start tests with 1971. But for second year performance and two-year rankings (underhounds), we need 70&71, so can start in 1972, and 1973 for second year effects. Show all three so we can get comparable periods.

Middle group is for 198-99 secular bull period. All three are available for the whole period, so all that is needed is appropriate lagging to line things up for the second and third year effects.

Last group is for secular bear periods 1971-81, 2000-03, but have the same beginning of period considerations as for whole period.

We see most effective is second year of underdogs or first year of underhounds, which incorporates some of the underdogs second year effects.

## “Winning with the Dow’s Losers” (2)

- Strategies to consider
  - Own “underdogs” from 2 years ago (HD, INTC, MCD, GE, IBM for 2004)
  - Own “underhounds” (T, SBC, HD, IBM, GE for 2004)
  - Better during secular bear markets
  - Will be more volatile than Dow or S&P

Based on graph in previous slide.



## “Winning with the Dow’s Losers” (3)

- Book has a lot in it
  - Other strategies
  - Extensive historical data back to 1931
  - History of the Dow
  - Anticipated Dow deletions (EK sure to go) and possible additions
- Recommended for Dow stock traders
- Web site: [www.dowunderdogs.com](http://www.dowunderdogs.com)

Obviously this was written before the changes in the Dow were announced on Thursday. EK has the smallest market cap of the current Dow stocks. The other two that were removed (T, IP) were on Carlson’s “on the bubble list,” and the three that came in (AIG, PFE, VZ) were all in his candidates list.

## “Trouncing the Dow”

- Book in 1998 by Kenneth Lee
- Target high, low prices based on
  - Current and 10-year average ROE
  - Current, 10-year average book value
  - 10-year average yearly highs, lows
- Buy “undervalued” stocks
- Sell rules not really specified
- Works best with large, fairly stable firms & can apply beyond Dow

This book takes a different approach. It has the advantage that it applies all the time, but the disadvantage that gathering all the data may be cumbersome. He does have a subscription service.

## “Trouncing the Dow” (2)

- Book has data for all Dow stocks 1991-96, some back to 1973
- Claims impressive real-time, backtested results
- Web site: [www.trouncingthedow.com](http://www.trouncingthedow.com)
  - Shows recent historical selections (Dow, non-Dow), results
  - Requires subscription for all full access, current selection

This looks like a worthwhile approach for those wanting to invest in blue chip and near blue chip stocks. Can do it themselves or subscribe to his service. I have not tested or tracked this because I prefer my own method (next slide), so I can't really evaluate it.

## Dow Turnarounds

- Buy & sell stocks in the Dow
  - First buy on “fresh” 52-week low
  - Buy more lots on 8-12% drops
  - Sell when 45% above average purchase price
  - Sell if gets 25% above average and then falls by 20%
  - Sell may factor in taxes, market conditions, available buy candidates
- Option strategies can be used

Gave talk on 1/4/03

Sell rule is simple, “average” version of the more complex rule I actually use. Also, deciding whether and when to sell can be complicated by what would be done with the sale proceeds. In strong markets when no new Dow stocks are buying candidate may want to hold and use some other method (e.g. chart reading) to decide when and at what level to sell.

Options strategies that are appropriate include selling puts instead of buying the stock and using a collar when the stock is near the selling target.

## New Buys in 2003

| Company                        | Purchase information |            |           | Sale/recent price information |       |              | Dow since    |
|--------------------------------|----------------------|------------|-----------|-------------------------------|-------|--------------|--------------|
|                                | Date(s)              | Avg. Price | # of Buys | Date                          | Price | Avg. %       | 1st buy      |
| <i>Boeing</i>                  | 2/20/03 - 3/6/03     | 27.32      | 2         | 11/13/2003                    | 40.00 | 46.4%        | 24.3%        |
| DuPont                         | 3/5/2003             | 35.01      | 1         | 4/2/2004                      | 43.71 | 24.9%        | 34.7%        |
| <i>General Motors</i>          | 3/7/2003             | 30.79      | 1         | 12/3/2003                     | 46.00 | 49.4%        | 35.3%        |
| <i>SBC Communications</i>      | 3/10/2003            | 19.56      | 1         | 9/24/2003                     | 21.88 | 11.9%        | 24.5%        |
| AT&T                           | 3/10/03 - 4/10/03    | 15.37      | 3         | 7/28/2003                     | 22.00 | 43.1%        | 22.4%        |
| <i>Altria (Phillip Morris)</i> | 3/12/03 - 3/31/03    | 32.38      | 3         | 7/8/2003                      | 47.00 | 45.1%        | 22.1%        |
| <i>Eastman Kodak</i>           | 7/21/03 - 9/26/03    | 23.41      | 3         | 3/22/2004                     | 25.20 | 7.7%         | 10.6%        |
| Johnson & Johnson              | 8/22/2003            | 49.09      | 1         | 4/2/2004                      | 51.18 | 4.3%         | 12.0%        |
| Merck                          | 10/20/03-10/24/03    | 46.51      | 2         | 4/2/2004                      | 45.06 | -3.1%        | 9.1%         |
| <b>Average:</b>                |                      |            |           |                               |       | <b>25.5%</b> | <b>21.7%</b> |

Page is part of information on my web site, which has similar data for all potential buys starting in 2000.

This table is included in the handout, so can refer audience to it and don't have to dwell on it.

Dow performance is good benchmark for stocks only bought once, but would need to use an average (not shown) for stocks with more than one lot bought.

Stocks shown in *italics* have been sold according the rules shown previously, but with my more complex target sale prices in some cases

No new buys so far in 2004. Closest are JNJ, MSFT. MRK is below hypothetical buy level, so it could be bought according to my methods.

I or clients have current positions (own stocks or option positions) in Kodak, J&J, SBC and Merck.

## Additional “Dow Quality” Stocks

- S&P Dividend Aristocrats
  - Have at least 25 years of dividend increases
  - List of 57 including 10 Dow stocks
  - Download Excel file from [www.standardandpoors.com](http://www.standardandpoors.com), search on “dividend aristocrats”
  - 3/29/04 Barron’s lists 26 with highest S&P ratings (7 are Dow stocks)
- Candidates for Dow Turnarounds, Trouncing the Dow methods

There are other stocks that are of high quality, so there is no claim the list is complete.

A company that has been able to raise its dividend for each of the last 25 years has shown outstanding financial strength and is clearly a well established business that is virtually certain to be a going concern for at least the next five years unless bought out or merged into another company. As such they are good candidates for purchase when their prices have been beaten down according to one of the methods discussed here or other ways of making that determination.

## Mark Pankin

- RIA since October 1994
- Managed account expertise/services
  - Market timing: tactical asset allocation
  - Dow Jones Industrial stocks
  - Sector fund trading (Fidelity, Rydex)
  - Portfolio design, rebalancing
- Much more at [www.pankin.com](http://www.pankin.com)
  - Click on Investments, then Managed Accounts, follow links
  - Info about Mark and his interests

I expect to post these slides on my web site.