GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Trading Note

The Dogs of the Dow

6th January 2012

Introduction

Many investment strategies require a fair amount of sweat and toil. If you are to have any chance of success, you need to pore over balance sheets, crunch the right numbers and keep abreast of company news.

But some approaches claim to make you money without the need to put in too much hard work. Chief among these is the strategy "Dogs of the Dow" made popular by Michael O'Higgins, the American fund manager, in his 1991 book "Beating the Dow".

Rule

This strategy exploits the tendency for stockmarkets to overreact to bad news, which highlights cheap shares. It takes the 10 highest yielding stocks in the Dow Jones Industrial Average and then invests an equal amount in the 5 that have the lowest absolute share prices. Leave the picks undisturbed for 12 months. After a year, the exercise is performed again and the portfolio changed to reflect the New Year's system selections and the accumulated dividend income reinvested.

Mr Higgins also suggests that you can achieve a similar performance with a single stock by selecting the 5 stocks but investing only in the one with the second lowest share price - the "penultimate profit prospect".

Performance

Buy these and you not only get a big income, but also the likelihood of capital gains when share prices recover. This strategy has returned on average 17.7% since 1973 and the UK version has performed in a similar manner (based on the FT30, the UK equivalent price-weighted index). It doesn't work every year but over time its results are impressive.

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The Dogs of the Dow (cont.)

Reasons for success

The strategy works because it encourages investors to buy stocks that are lowly rated and, hopefully, will be revalued. Because the market often overcorrects, stocks like these are frequently priced too low. But the system only works if persued with studious inactivity, without any tinkering or second-guessing. Remember that the system is purely mechanical. It involves no consideration of fundamentals, forecasts, charts, consensus views of analysts or any of the normal paraphernalia of investment decision-making. The only data used are dividend yield and price. It's that simple.

Current Selection

Name	Sector	Price	Projected P/E	Projected Yield	Dividend Cover
Man Group PLC	Financial Services	125p	8.9x	12%	1.3x
RSA Insurance Goup PLC	Nonlife Insurance	107p	7.4x	8.7%	1.1x
Vodafone Group PLC	Mobile Telecommunications	176p	11.3x	7.2%	2.4x
Logica PLC	Software & Computer Services	66p	6.7x	6.7%	3.1x
Ladbrokes PLC	Travel & Leisure	131p	9x	5.7%	5.7x

Recommendation

We recommend investors buy the "penultimate profit prospect" RSA Insurance Group Plc. Trading on a sub 8x p/e ratio and yielding more than 7% (covered 1.1x) the stock is rated a buy by the majority of analysts with Citigroup having a price target of 145p indicating 34.9% upside (not including dividend income) on today's 107.5p share price.

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