

This year's Darlings

Looking for consistent profitability and low volatility? Buy high-yield, low-priced Dow stocks that also have low P/S ratios and low cash-flow ratios. These "darlings" might become the apple of your investing eye.

BY LARRY WILLIAMS



2003 has been a good year for the stock market and an even better year for the Darlings of the Dow, a stock selection and timing technique outlined in *Active Trader* in April 2002 (see "Additional research," p. 81, for more information).

Market traditionalists have often extolled the advantages of buying the so-called "Dogs of the Dow," which are low-priced, high-yielding Dow Jones Industrial Average (DJIA) stocks. However, historical research (and recent performance) has shown the "Darlings of the Dow" — those DJIA stocks with the best fundamental ratings based on scans of dividend yield, cash flow and price-to-sales (P/S) ratio, among others — provide a better balance of return and risk. Table 1 (right) shows the performance of last year's Darlings of the Dow.

The Darlings of the Dow strategy consists of buying DJIA stocks based on the relationship between certain fundamental valuation measures, especially 12-month forward price-to-earnings (P/E) ratio, price-to-sales (P/S) ratio, dividend yield and cash-flow ratio. Before looking at this year's selections, let's review the principles driving this approach.

Taking care of risk first

The Darlings of the Dow concept is simple: Making consistent, long-term money in the stock market is not so much about buying stocks that go up as it is about avoiding stocks that go down.

While stocks that go up never hurt anyone, the ones that get clobbered damage portfolio performance. By avoiding or sharply limiting your exposure to these stocks, you can improve the odds of coming out ahead of the long-term investing pack. So, rather than focusing on momentum or "hot" stocks, the key is to look for solid value stocks.

Because the DJIA contains real companies, with real products and real perform-

ance records going back many years, its components are a logical group from which to select such stocks. These are not high-flying momentum issues; they represent substantial companies that are not subject to every whim of the market. Several value measures can be used to find the best stocks to select from this universe.

Fundamental factors

The first fundamental criterion to consider is a new one for the Darlings of the Dow: the 12-month forward P/E ratio, which is a readily available forecast of what a company's P/E should be 12 months from now. Testing shows stocks with low 12-month forward P/E ratios substantially outperform the market.

The P/S ratio is the second-best measure of future performance for the DJIA stocks. The lower the ratio, the better the value.

Momentum does not change these relationships. A test spanning 1976-2001 (from the first "Darlings" article) that consisted of buying the five stocks with the highest relative strength ratings and highest P/S and P/E ratios — which essentially combines the concept of positive current momentum with lack of value (the classic combination of high-flying stocks) — produced the poorest performance. Further tests showed low dividend yields and high cash flow also are impediments to market profits.

The Darlings of the Dow are low-priced DJIA stocks that also have low P/S ratios and low 12-month forward P/E ratios. The selection technique is simple: Subtract the P/S and cash-flow

TABLE 1 OCTOBER 2002 DARLINGS OF THE DOW SELECTIONS

Positions in the following stocks were entered on Oct. 28, 2002, and exited on June 26, 2003. The same entry and exit point in the Dow Jones Industrial Average would have produced an 8.1-percent gain.

Company	Close 10/28/2002	Close 6/26/2003	Net change	Dividend return	Gross change
Caterpillar Inc. (CAT)	40.470	56.76	+40.25 %	2.05	+42.30 %
General Motors (GM)	34.880	35.94	+3.04 %	1.10	+4.14 %
Honeywell Int. (HON)	23.680	27.25	+15.08 %	1.85	+16.93 %
J.P. Morgan (JPM)	21.250	34.40	+61.88 %	2.01	+63.89 %
Phillip Morris (MO)	41.640	44.78	+7.54 %	2.32	+9.87 %
Total (%)			+25.558		+27.42

ratios from the stock's dividend yield. The stocks with the highest figures are the ones to buy — when the time is right. (For more details, refer to *The Right Stock at the Right Time*, listed in "Additional research.")

This approach is not just about buying high rate-of-return stocks, it's about buying the most fundamentally sound stocks, which should also be the stocks least resistant to declines. Will they rally as much as some other stocks? Probably not. You can always find hotter stocks, but hot stocks have too much downside risk.

The timing element

The Darlings strategy is also enhanced by timing. Although the Dogs of the Dow strategy buys its stocks on the first of the year, there is ample historical evidence that from year to year stocks post most of their gains from October to May (although no rule in the market is without its exceptions).

Timing the market with this seasonal tendency pays off in high returns as well as reduced risk. For example, if you simply bought the five DJIA stocks with the highest yields and the lowest cash-flow ratios at the end of October and exited six months later, your average annual return would have been 18.7 percent. The rest of the time you would be in cash, collecting at least 2 percent on your money, netting an average of 20.7 percent per year. Not only is the return high, but the approach also would have avoided the crashes of 1966, 1969, 1970, 1973, 1974, 1977, 1981, 1987, 1990, 1998, 1999, 2000 and 2001.

Adding the October-May seasonal tendency to the fundamental valuation criteria in the previous section completes the Darlings of the Dow strategy. The 2001 to 2002 Darlings selections were up 17.4 percent. In 2000-2001, the Dogs of the Dow lost 4.9 percent while the Darlings of the Dow posted a net gain of 15 percent.

Changing with the times: Understanding the new filter

While last year's performance again made clear value matters, this year's new 12-month forward P/E criteria calls attention to the need to continually assess and refine strategies. Keep in mind that although "undervalued" ultimately implies a stock should go higher, value alone does not make a stock move up. Many undervalued stocks languish for months (even years) before being appreciated again by the marketplace. While value may attract nibblers, it increasingly appears that earnings attract aggressive buyers.

This is why this year's Darlings are based first on a search for the five to 10 best-valued stocks in the Dow, using the existing rules, and then on a scan for those stocks with the largest


projected percentage earnings growth over the next 12 months.

For example, on Sept. 25, 2003, Boeing (BA) had 93-percent expected growth in earnings for the next 12 months, yet its 12-month forward P/E ratio was close to 38.1 — too high for the bargain-searching Darlings of the Dow strategy. In other words, this stock has great growth potential but is overvalued.

By contrast, Kodak (EK) had a projected earnings gain of about 20 percent and a very low 12-month forward P/E ratio (around 10). In this case, yes, we have an undervalued stock with high-growth potential. Table 2 (above) shows this year's Darlings of the Dow (as of Sept. 30) using the revised fundamental criteria.

The suggested entry time for the Darlings is the last week of October, or any serious market oversold point during the month (check valuations and make selections at this time). Dance with these darlings for six months (i.e., the end of April 2004). You can even propose to them, but don't marry them for more than nine months (i.e., get out at the end of July at the latest). You can track the weekly results of the Darlings at www.commoditytrading.com.

Other ideas

Other approaches to potentially enhance the Darlings of the Dow model include adding an average gain of five percent to the yearly returns by moving into various groups of similarly selected stocks that have shown a strong seasonal tendency to rally from April-May into early October. 

"Darlings of the Dow" is a registered trade-mark.

For more information on the author see p. 12.

Valuation measures

Price-to-sales ratio: Stock price divided by revenues per share.

P/E ratio: Stock price divided by earnings per share.

Price-to-book ratio: The current closing price of the stock divided by (usually) the latest quarter's book value (assets minus liabilities). Used to compare a stock's market value to its book value.

Price-to-cash-flow ratio

(or "cash-flow ratio"): Price per share divided by cash flow per share. (Cash flow is the amount of cash a company creates and uses over a certain period. It is calculated by adding non-cash charges (e.g., depreciation) to after-tax net income.

Dividend yield: Annual dividends per share divided by price per share.

Additional research

The Right Stock at the Right Time by Larry R. Williams (John Wiley & Sons, 2003).

"The Darlings of the Dow," by Larry Williams. *Active Trader*, April 2002, p. 84.

"Larry Williams: Marathon Man," *Active Trader*, December 2002, p.74.

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TABLE 2 2003-2004 DARLINGS OF THE DOW

These are selected stocks for this year. This list was compiled as of 9/30/03. These ratios may change before the designated entry period, which is the last week of October.

Stock	12-mo. forward P/E	P/S	% Earnings Inc.
Eastman Kodak (EK)	10	.65	21.0
Altria (MO)	9	1.15	6.6
Citigroup (C)	14	2.50	12.6
Hewlett-Packard (HPQ)	18	.90	23.0
Home Depot (HD)	18	1.29	12.0