By Hugh Dive 17th December 2015

Dogs of the ASX …. Ruff Ruff !

The "Dogs of the Dow" is an investment strategy that is based on buying the ten worst performing or highest yielding stocks in the Dow Jones Industrial Average (DJIA) at the beginning of the year. The strategy then holds these ten stocks over the calendar year and sells these stocks at the end of December. The process then restarts, buying the ten worst performers or highest dividend yielders from the year that has just finished.

Following outsourcing services provider Spotless' 49% fall in December (which wiped A$1.2 billion off its market capitalisation), in this week's piece we are going to look at the "dogs" of the ASX, focusing on large capitalisation Australian companies with falling share prices. Additionally I am going to sift through the trash to try to discern any fallen angels.

Unloved Mutts

The Dogs of the Dow made famous by O'Higgins in his 1991 book "*Beating the Dow*" and seeks to invest in the same manner as deep value and contrarian investors do. Namely, invest in companies that are currently being ignored or even hated by the market; but because they are included in a large capitalisation index like the DJIA or ASX 100, these companies are unlikely to be permanently broken and may have the financial strength or understanding capital providers; (shareholders and banks), that can allow the company to recover over time.

Dogs over the Past Five Years

The table below looks at both the top and bottom performers for the past five calendar years and their performance over the subsequent 12 months. As always this is measured on a total return basis, which looks at the capital gain or loss after adding in dividends received. Whilst sifting through the trash at the end of the year yields the occasional gem such as JB Hi-Fi in 2014 (+21%), Qantas in 2013 (+92%) and Challenger in 2012 (+81%), an equal weighted portfolio of the dogs of the ASX 100 has underperformed the index in 4 of the past five years.

Company	Industry	Worst Performers in 2014	Return in 2015	Company	Worst Performers in 2013	Return in next year	Company	Worst Performers in 2012	Return in next year	Company	Worst Performers in 2011	Return in next year	Company	Worst Performers in 2010	Return in next year
Arrium Ltd	Steel	-81%	-68%	Newcrest	-64%	34%	Iluka	-37%	-3%	BlueScope Steel Ltd	-78%	42%	Downer EDI Limited	-48%	-28%
Fortescue Metals	Mining	-49%	-33%	Graincorp	-28%	0%	Sims Metal	-25%	18%	Alumina Limited	-52%	-17%	Primary Health Care	-33%	-16%
Santos Ltd	Energy	-41%	-47%	Echo	-27%	54%	Fairfax	-25%	29%	Fairfax Media Ltd	-46%	-25%	Harvey Norman	-27%	-34%
ALS Ltd	Mining Services	-36%	-27%	Qantas	-27%	92%	Newcrest	-24%	-64%	Qantas Airways	-43%	2%	BlueScope Steel Ltd	-26%	-78%
WorleyParsons	Energy Services	-34%	-49%	WorleyParsons	-25%	-32%	Alumina	-17%	24%	CSR Limited	-41%	5%	Aristocrat Leisure	-25%	-25%
Iluka Resources	Mining	-30%	-11%	Cochlear	-22%	28%	QBE	-11%	8%	Sims Metal Mgmt Ltd	-39%	-25%	QBE Insurance Group	-24%	-22%
Flight Centre Travel	Retail	-28%	11%	Mondadelphus	-8%	-43%	Challenger	-10%	81%	Cimic Group Ltd	-35%	-2%	Sonic Healthcare	-21%	2%
JB Hi-Fi Limited	Retail	-23%	21%	Incitec Pivot	-14%	15%	Origin Energy	-9%	25%	Fortescue Metals Grp	-34%	11%	James Hardie Indust	-20%	1%
Crown Resorts Ltd	Gaming	-22%	-12%	ALS	-13%	-36%	Santos	-7%	35%	Harvey Norman	-34%	8%	Macquarie Group Ltd	-20%	-31%
BHP Billiton	Mining	-19%	-28%	Coca-Cola	-6%	-18%	Worley	-5%	-25%	JB Hi-Fi Limited	-33%	-3%	Fairfax Media Ltd	-18%	-46%
ASX 200			-3%	ASX 200		6%	ASX 200		15%	ASX 200		15%	ASX 200		-11%
Average		-36%	-24%	Average	-23%	9%	Average	-17%	13%	Average	-43%	0%	Average	-26%	-28%
Dogs Beat the Index			NO			YES			NO			NO			NO

Themes

Looking at the above table finding the fallen angel amongst the worst performers seems to work best where the underperformance is due to stock specific issues, rather than macro issues beyond a company's control. For example, Cochlear underperformed in 2013 after weaker sales as the company waited for approval to sell its new Nucleus 6 product in the United States. Subsequently, Cochlear's share price has doubled as hearing-implant sales bounced back. Similarly JB Hi-Fi underperformed in 2014 on concerns that the retailer's sales growth had stalled, in 2015 the company bounced back and reported strong sales growth as JB Hi-Fi took market share off competitors such as Dick Smith.

The common factor amongst the underperformers that have continued their slide in the following year is when the underperformance is tied to factors outside the company's control such as a multi-year decline in a commodity. From the list of underperformers in 2014, continuing declines in iron ore delivered further pain to Arrium, Fortescue and BHP's shareholders. Similarly declining oil prices pushed down the share prices of Santos and Worley in the subsequent 12 months.

Unloved Hounds as of December 2015?

As a fund manager the key question is whether there are potential show champions in the breed of unloved canines tabled below for the 2015 calendar year. Former market darling Slater & Gordon (up 34% in 2014) faces a challenging path to restore credibility with investors with significant questions remaining about the value of the A$1.3 billion Quindell acquisition, after proposed changes to UK injury laws will limit payouts to sucessful plaintiffs (and their lawyers). Similarly Spotless which climbed 54% since listing in May 2014, was significantly de-rated after issuing a surprise profit downgrade. We would also be unwilling to suggest that Spotless would be a candidate for the diamond in the rough, as after its 50% fall price, it trades on roughly the same PE ratio as it did in the ten years before it was bought and "transformed" by private equity in 2012.

Company	Industry	Return in 2015	Reason for Large fall
Slater & Gordon	Legal	-81%	Poor Acquisition/accounting trust issues
Arrium Ltd	Steel	-72%	Falling iron ore prices
Beach Energy Limited	Energy	-55%	Falling Energy prices
WorleyParsons Ltd	Engineering Services	-52%	Falling Energy prices
Origin Energy	Energy	-52%	Falling Energy prices
Santos Ltd	Energy	-50%	Falling Energy prices
Sims Metal Mgmt Ltd	Steel	-45%	Falling scrap metal prices
Mineral Resources.	Mining Services	-43%	Falling commodity prices
Spotless Grp	Services	-36%	Surprise downgrade from new IPO
Primary Health Care	Healthcare	-35%	Operational issues/accounting concerns

The energy related companies (Beach, Santos and Origin) look to be in a challenging position and a recovery in their share prices will largely be out of their control, probably resting on the ability of OPEC to come to some agreement to curtail production to support prices. Without providing any particular stock recommendations looking at the "Dogs of the ASAX" we see that the energy stocks are the most likely out of this group of ten to show a recovery in 2016, but we recognise that the outlook for oil is opaque and that it may be politically expedient for low oil prices to maintain the pressure on nations such as Russia, Iran and Venezuela.

Our View

Whilst the Dogs of the Dow might work in a market populated with a diversified range of companies in uncorrelated industries such as McDonalds, 3M, Merck and Microsoft, it does not appear to be a broad strategy that one can use consistently on the ASX. We see that the degree of correlation amongst the companies in the ASX 100 to external macro factors (such as the oil price) outside of management's control can be subject to multi-year declines. Nevertheless it can pay to sort though the dogs of the ASX. From the table above over the past 4 years, one of the top performers in the following year can be found by shifting through the dogs of the ASX100.

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