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Financial Analysts Journal ›

Volume 59, 2003 - Issue 1

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PORTFOLIO MANAGEMENT

Dividend-Yield Strategies in the Canadian Stock Market

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Pages 99-106 | Published online: 02 Jan 2019

Cite this article https://doi.org/10.2469/faj.v59.n1.2506

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Abstract

The "Dogs of the Dow" strategy has become an increasingly popular investment strategy for unit investment trusts, resulting in superior performance for U.S.-based investors. To examine its effectiveness for Canadian investors, we applied this high-dividend-yield strategy to the Toronto 35 Index for the first 10 years of the index's existence. The 10 top-performing portfolios' higher compound returns were sufficient to compensate for taxes and transaction costs. Perhaps more important, both the Sharpe ratio, which measures excess return to total risk, and the Treynor index, which measures excess return to market risk, indicate that the strategy produced higher risk-

adjusted returns than the Toronto 35. The Dogs strategy also performed well against the broader, but similar, Toronto Stock Exchange 300 Index.

The “Dogs of the Dow,” a popular dividend-yield strategy, involves purchasing the 10 highest-dividend- yielding stocks on the DJIA on 31 December and rebalancing on an annual basis. This strategy is one of many value-based investment strategies being used in the U.S. market that have been explored in the financial press and the academic literature in recent years. The success of value-based strategies has also been investigated in international markets, with the Canadian market showing mixed results. In the study reported here, we investigated whether the Dow Dogs dividend-yield strategy is effective in the Canadian stock market.

We compared the performance of the 10 highest-dividend-yield stocks in the Toronto 35 Index with the performances of both the Toronto 35 and the Toronto Stock Exchange (TSE) 300 Index for the 1987–97 period. We obtained data on the constituent companies, as well as returns for both indexes, from the TSE Review. We collected dividend yields on all of the Toronto 35 companies for the last trading day of July 1987 through 1997 from Research Insight. The 10 companies with the highest dividend yields composed the equally weighted Top 10 portfolio each year. The monthly returns for each stock include the price change and dividends, divided by the beginning price. We calculated the Top 10 portfolio return by investing C$10,000 in each stock on 1 August. Each C$10,000 investment was increased by each individual stock's August return. We added the end-of-August stock values to determine the portfolio value. We used the percentage change in portfolio value during the month for the monthly portfolio return. We multiplied the Canadian dollar value of each stock investment at the end of August by each stock's September return, summed the 10 stock values, and calculated the September portfolio ending value and return. We repeated this process for each of the 12 months. Then, we repeated the process for the following year by investing C$10,000 in each of 10 potentially new stocks on 1 August.

The Top 10 portfolios' compound returns were between 1.2 percentage points and 20.4 percentage points greater than those of the index in eight years and were lower than the index by relatively small amounts (2.8 pps and 3.6 pps) in the other two years. The Top 10 portfolios also beat the Toronto 35 in the six consecutive 5-year periods and over the entire 10-year period. The strategy was successful even after taxes and transaction costs were taken into account.

We also examined the returns on a risk-adjusted basis. The Sharpe ratio (excess return per unit of total risk) is the appropriate measure of risk-adjusted return when the investor is not well diversified and is exposed to some level of company-specific risk. When we calculated Sharpe ratios, the results were similar to the compound return results: The Top 10 portfolios outperformed the Toronto 35 in eight single-year periods and all the multiyear periods. If the Canadian Dogs strategy is part of a larger, well-diversified portfolio, the investor is exposed only to systematic risk and the Treynor index is the appropriate measure of risk. Calculating this measure, we found, again, that the Top 10 portfolios outperformed the Toronto 35 in the same eight single years and all multiyear periods.

In addition, the strategy performed well against the broader, but similar, TSE 300 Index.

We would like to thank Ed Nelling and Dianna Preece for their helpful comments.

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