



Dow Theory

By CK Wong 2005.12.25

<http://www.ck-wong.ca/money%20matters/dow%20theory%201%2020051225.pdf>

Introduction

Charles Dow developed the Dow Theory at the beginning of Twentieth Century. It has been over a century. The brilliant theory has been tested and tested over a century. Its authority is unquestionable. The financial community in the Nineteenth Century may largely be the same as the current one. Nonetheless there are subtle differences. Is there any room for improvement? Originally I want to write a quick and short one. Only research the material for 15 minutes, I decided to do myself a great favor not to do it yet until I finish the study of the Dow Theorists' work.

Brief History of Dow Theory

There are two well written articles on the history of Dow Theory. I would not repeat here. Reader could refer to reference 1 and 2 for details. In summary, Charles H. Dow developed a concept from his personal experience on the inner working of the Wall Street stock market. His concept was published as 15 editorials on Wall Street Journal starting 1902. His successor of WSJ, William P. Hamilton, continued his practice by publishing 252 articles based on Dow's concept with his own from 1903 to 1929 on WSJ and *Baron's*. Hamilton's student Robert Rhea was midwife who codified the theory to a practice. Hamilton's successor Rhea started an advisory service *Dow Theory Comments* in 1932 until his dead in 1939. In 1948 another Dow theorist E. George Schaefer started the *Schaefer's Dow Theory Trader* advisory service. Schaefer emphasized on value of the stock.

I would like to quote his philosophy which will be very valuable to investor but not to trader. Once stocks are purchased, both the minor and secondary movements in the market should be completely disregarded. A new period of prosperity will follow, once the present recession has run its full course."

In 1957 Richard Russell started his Dow Theory advisory service on *Barron's* and later as an independent continued until now.

Investment vs. Trading

There are two philosophies among those who play in the stock market. The first one believes that we could take advantage of the primary and secondary up and down of a stock to maximize the gain (long or short). The second one believes the sudden movement of the market in short term is driven by unpredictable factors. It is the very long cycle (i.e., from bull to bear or from bear to bull) that could be predicted. Buy or sell should happen only at the apex. Dow theorists emphasize the value of the stock. They tend not to trade for short term in order to maximize the end to end gain.

If the market movement is not the only indicator, one has to choose the stock base on attributes that can be tested and measured explicitly. One of the common attribute used is value. There is a wide range of indicator people could use to measure value: PE, book value and dividend.

Dividend has been a very powerful indicator for the strength and the quality of the management. High yield could mean a good healthy company that accepted by the market. A short period of health dividend could be luck. Tens of years of continuous high yield has to be strong management. I would introduce an example here, AT&T pays dividends event through the Depression. The management at that tough period could not be just lucky. They have to balance the expenditure and revenue as well as coping the market demand. When Depression is over, AT&T emerged as the Ma Bell and the rest is history. When AT&T forced to break up into Regional Bell Operating Company (RBOC), the strength of management weakened. You know the story.

A high yield and reasonable payout ratio stock is a heavy stock that it has a steady source of income and the market supports it. However, one should be careful not to be confused between high yield than high payout ratio. In some income trusts, they are not just pay out the income but also capital. The capital draw down likes the living style of American: financed by debt. It is dangerous.

When one adopts an investment philosophy, many factors could be considered. For low risk retail investor, value is highly recommended. To find the value, one should do the homework in conjunction with professional advice.

One of the pain to do long term investment is mental. You watch the stock goes up and down and feel that I should sell at the short term high and buy back at the short term low. If one could do that prediction, many other can do too. The market will not be at the peak or valley because of the additional transactions.

References

1. *History of Dow Theory* by Richard Russell
http://ww2.dowtheoryletters.com/DTLOL.nsf/htmlmedia/body_the_history_of_the_dow_theory.html
2. *Dow Theory* from StockChars.com
<http://www.stockcharts.com/education/MarketAnalysis/dowtheory1.html>