A CLOSER LOOK AT FUNDS THAT FOCUS ON THE DOW

By Albert J. Fredman

The Dow Jones industrial average is the most widely followed market indicator, and now investment products that feature Dow stocks are starting to attract attention.

Probably the best-known gauge of the stock market is the Dow Jones industrial average. Introduced in 1896 by Charles H. Dow, the Dow has served the test of time.

In 1997, Dow Jones & Co. decided to license its renowned market indicator for a variety of options, futures, and stock index products. Now individuals can choose among several index vehicles that replicate this blue-chip yardstick, just as they've been able to invest in Standard & Poor's 500 index funds since John Bogle launched the Vanguard Index 500 portfolio in 1976.

The S&P 500 index fund category had $106.9 billion in total net assets at year-end 1997, according to Lipper Analytical Services. The Vanguard 500 had $48.3 billion at that time, making it the second largest fund in the world. The popularity of S&P 500 funds leads me to believe that the emerging group of Dow index funds will attract plenty of attention. A household name like the Dow is comforting to mainstream investors.

With the exception of ASM Index 30 Fund, which began in 1991, no Dow 30 index portfolio existed until the American Stock Exchange's Diamonds were launched in January 1998. Since Dow Jones & Co. has agreed to license its name, a handful of Dow-based products have debuted, including futures and options contracts that trade on Chicago exchanges. ASM Index 30 was able to track the Dow 30 because its previous name—simply "ASM Fund"—bore no resemblance whatsoever to the Dow. That was changed in December 1997 to the more descriptive ASM Index 30.

Other portfolio products focus on Dow stocks in a different way—notably, those that follow a Dow Dogs strategy. Dow Dogs portfolios were first offered in 1991 as unit investment trusts, although several mutual funds now follow a Dow Dogs strategy. Because a Dow Dogs portfolio does not mimic the Dow 30, licensing from the Dow Jones & Co. is unnecessary.

This column focuses on funds that feature Dow stocks, either through indexing or a strategy using Dow stocks.

THE DOW 30

The Dow Jones industrial average (DJIA) reflects the average price of 30 U.S. blue-chip stocks. Originally made up of 12 industrial companies, the yardstick had expanded to 30 by 1928. Table 1 identifies the companies presently found in the Dow.

In the beginning, the closing prices of 12 industrials were simply summed and divided by 12 to obtain the average. But the Dow's divisor has been adjusted (usually downward) over the years to avoid distortions that otherwise would result from share splits, the payment of large stock dividends, or the occasional substitution of a new company. In 1997, 20 changes occurred in the Dow's divisor. The divisor recently stood at about 0.25. That's why the average itself is much higher than the prices of any of the stocks. Adjusting the divisor maintains consistency in the readings.

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TABLE 1.
STOCKS INCLUDED IN THE DOW JONES INDUSTRIAL AVERAGE

Alcoa	Hewlett-Packard
AlliedSignal Inc.	International Business Machines Corp.
American Express Co.	International Paper Co.
AT&T Corp.	Johnson & Johnson
Boeing Co.	McDonald's Corp.
Caterpillar Inc.	Merck & Co., Inc.
Chevron Corp.	Minnesota Mining and Manufacturing Co.
Coca-Cola Company	J.P. Morgan & Co. Inc.
Walt Disney Co.	Philip Morris Companies Inc.
EI duPont deNemours & Co.	Procter and Gamble Co.
Exxon Corp.	Sears, Roebuck and Co.
Eastman Kodak Co.	Travelers Group Inc.
General Electric Company	Union Carbide Corp.
General Motors Corp.	United Technologies Corp.
Goodyear Tire & Rubber Co.	Wal-Mart Stores, Inc.

The Dow has been criticized for containing only 30 companies, but the firms have been carefully selected to represent different economic sectors. Care is taken to ensure that all 30 companies represent the broad economy over time. Thus, the Dow's composition is modified from time to time to reflect changes in the economy. Since the mid-1950s, the substitutions have mirrored the growing importance of technology, service, and entertainment firms. Four stocks were replaced last March. The Wall Street Journal's editors are responsible for making all changes in the Dow.

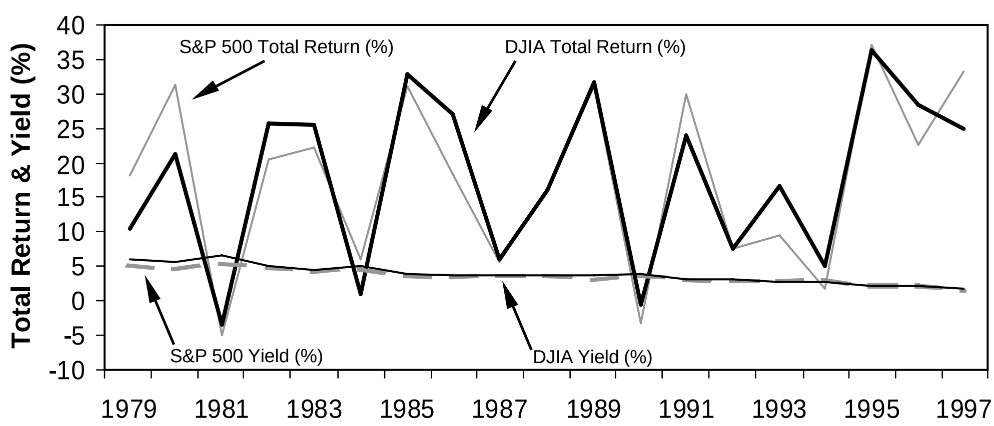
Major differences exist in the way the DJIA and the S&P 500 are constructed. The DJIA is price-weighted: Only the share prices of the 30 component stocks are used to derive its value. That means that higher-priced stocks, which are not necessarily the biggest companies, will affect the average more than lower-priced ones. In contrast, the S&P 500 is weighted based on the market capitalization (price per share times number of shares outstanding) of each of its 500 stocks. Thus, with a market value of $246 billion, General Electric will have the biggest effect on the S&P 500. The stocks in the S&P 500 represent about 72% of the U.S. stock market.

In spite of their differences, the returns of the Dow and S&P 500 are highly correlated over time. Figure 1 shows the annual total returns and yields of the two indicators since 1979.

Most actively managed funds underperfomed both the S&P 500 and the Dow during the majority of years. Table 2 shows the percentages of general domestic equity funds that beat the Dow over each of the past 10 years, according to data provided by Lipper Analytical Services. The largest percentage beating the Dow was 78% in 1991; the lowest was 7.4% in 1996. For the decade ended December 31, 1997, only 11.5% or 50 of the 434 funds in existence for the full 10 years outpaced the Dow. In addition, there is survivorship bias in these data—only currently existing funds are counted.

There are several reasons for this underperformance, including the fact that funds incur management fees and trading costs. In addition, managed funds hold cash, whereas a market index is purely stocks. Finally, many domestic stock funds also have some exposure to smaller stocks as well as foreign stocks, so their returns are diluted when these two groups underperform the Dow.

FIGURE 1. THE DOW VS. THE S&P 500



Source: Bloomberg Financial Markets

DIAMONDS

One of the newest Dow products are Diamonds. A hybrid between an open-end and a closed-end fund, Diamonds (ticker symbol DIA) began trading on the American Stock Exchange on January 20. That day, 1.7 million shares changed hands, making Diamonds the most heavily traded new product in Amex history. Since their debut, daily volume has averaged about 700,000 shares. Total net assets amounted to about $260 million recently.

As a basket of the 30 Dow stocks, Diamonds are structured like the Amex's Spiders (or SPDRs; ticker symbol SPY), which replicate the S&P 500. The latter product was introduced in 1993 and has since become the Amex's most actively traded stock, averaging about four million shares daily. Spiders now have more than $6.5 billion in assets. As index funds, Diamonds and Spiders remain fully invested and adhere to a buy-and-hold policy. Because of the public's familiarity with the Dow, Diamonds could hold even more interest for individuals than Spiders.

Like Spiders, Diamonds technically represent an interest in a unit investment trust containing a basket of stocks that replicate the price performance and dividend yield of the underlying benchmark. A unit investment trust is a fixed portfolio that is held for a limited duration. The traditional unit investment trust does not trade on an exchange and has a much shorter life. Conversely, Diamonds are exchange-traded and the trust is set to expire in the year 2123.

Expenses for Diamonds are 0.18%, at least a full percentage point below the typical actively managed stock fund, and slightly less than the 0.19% expense ratio on the penny-pinching Vanguard 500. Because Diamonds follow a buy-and-hold policy, they are highly tax-efficient when held as a long-term investment. They can be even more tax-efficient than a garden-variety index fund because it would not be necessary for the management to sell shares from the portfolio to meet investor redemptions during a severe market downturn. That's because cash redemptions are not possible—only in-kind redemptions can be made. Spiders, for instance, have distributed only nine cents a share in capital gains over the past five years.

Dividends (net of trust expenses) are declared and paid monthly. Diamonds go ex-dividend the third Friday of each month. The ticker symbol DJD provides month-to-date accrued dividend amounts daily. The symbol DXP reports the final dividend payment, which can be determined anytime between Diamonds' ex-dividend date and payment date. Dividend reinvestment is possible if your brokerage offers it. The monthly payment stream may complicate matters somewhat for those who want to reinvest.

TABLE 2.
GENERAL EQUITY FUNDS THAT OUTPERFORMED THE DJIA*

Year	DJIA Return (%)	Percentage of Funds Beating Dow (%)	Total Funds
1988	16.21	46.3	434
1989	32.24	16.3	459
1990	–0.54	23.9	494
1991	24.25	78.0	551
1992	7.40	60.6	587
1993	16.97	25.4	795
1994	5.02	9.0	813
1995	36.94	19.9	998
1996	28.91	7.4	1,183
1997	24.91	54.4	1,462

**Including reinvested dividends; these data eliminate multiple classes of shares per fund and thus, represent funds rather than classes.*

Source: Lipper Analytical Services, Inc.

PRICING AND TRADING

Each Diamond is priced at 1/100 of the Dow. With the indicator at 9000, for instance, a Diamond would trade at about 90 (the share price and net asset value should also reflect the value accrued dividends from stocks in the portfolio). Each 100-point change in the Dow equates to a one-point change in a Diamond. Like ordinary mutual funds, Diamonds provide a daily net asset value, which is computed after the close of trading. The trading symbol DXN allows you to determine the net asset value.

Unlike closed-end funds, Diamonds trade at or very close to their net asset value. That's because Diamonds allow large professional investors to make in-kind investments and redemptions by delivering or taking delivery of baskets of stocks corresponding exactly to the Dow. These so-called "creation units" consist of 50,000 Diamonds, or multiples thereof. The possibility for professional arbitrageurs to exploit significant differences between share price and net asset value ensures that any difference between the two remains minimal. However, price can deviate from net asset value slightly during brief periods due to factors such as extreme market volatility.

Diamonds trade like a stock at varying prices throughout the day. They can be bought on margin and sold short at any time during the trading day by those so inclined (although these are risky strategies that normally are not recommended for individuals). An advantage of Diamonds is that you can place limit orders to buy or sell shares at your target price or better. Conversely, with a mutual fund you must trade at the closing net asset value on the day your trade is executed, so you have less control over price. Of course, those who like to track their investments throughout the day can still mistime their trades during a volatile session. That's why using a limit order is often preferable to a market order.

The normal brokerage commission applies to both purchases and sales of Diamonds, which trade in price increments as small as 64ths. The bid-asked spread typically is 1/16 point. Commissions can be reduced significantly by using a discount broker and perhaps also trading on-line. For a prospectus and other information on Diamonds, contact the Amex at 1-800-THE-AMEX or on the Internet at http://www.amex.com.

TABLE 3.
DOW DOGS VS. UNMANAGED DOW AND S&P 500

Period (Through 12/31/97)	Average Annual Total Returns (%) Dow Dogs Strategy*	DJIA	S&P 500 Index
3-Year	26.24	29.85	30.82
5-Year	20.69	21.81	20.06
10-Year	17.31	18.41	17.89
15-Year	18.36	18.21	17.37
20-Year	16.70	16.33	16.41
25-Year	16.09	13.01	12.85

**Strategy returns are net of sales charges and expenses.*

Source: Merrill Lynch

A DOW 30 MUTUAL FUND

As mentioned earlier, ASM Index 30 Fund has been replicating the Dow since 1991. However, this $38-million Tampa, Florida-based no-load fund was not well known in part because its earlier name did not reflect its objective. In addition, the fund lagged its benchmark because of its high expenses and cash holdings. In January 1997, ASM's adviser decided to cap its expense ratio at 0.18% in an effort to minimize its tracking error. In addition, cash holdings also have been reduced to less than 1% of assets and its present name is more descriptive. Additional Dow 30 index funds should become available now that the famous trademark can be licensed. However, the Vanguard Group, which has more than $118 billion in assets in its 16 index funds, currently has no plans to introduce a portfolio that will track the Dow.

Do you need a Dow index fund if you already own an open-end S&P 500 portfolio or Spiders? No, because the correlation between the two indexes has been very high over the long term. The main advantage that a Dow 30 fund appears to have over an S&P 500 portfolio is that it allows investors to replicate the world's most familiar and widely talked about market benchmark. The idea of having an interest in a tried-and-true household name like the Dow may be psychologically comforting to many individuals.

However, some feel that a price-weighted index fund tracking the Dow might carry a greater potential tax liability than a value-weighed S&P 500 portfolio. Specifically, when a Dow stock splits, a substantial capital gain may have to be realized and distributed to shareholders. For instance, in a 2-for-1 split, a $100 stock would fall to $50 and the holder would own twice as many shares. To restore proper weighting, a fund manager would sell the excess shares and reallocate the proceeds to the other Dow stocks. (Because the S&P 500 is value-weighted, no adjustment need be made when a company splits since the stock's total market value is not changed.) Nevertheless, the Amex feels that stock splits will not be a problem for Diamonds.

Some might also question the dangers of including only 30 stocks in an index fund. After all, an S&P 500 portfolio normally contains 500 stocks. But according to widely accepted academic research, most of the company-specific risk is eliminated from a portfolio by holding as few as 16 to 20 stocks. The problems that drag down some companies will be offset by the good fortunes that drive up others. Thus, 30 stocks are more than adequate, especially in the Dow's case because the 30 are large, blue-chip companies. The Dow companies are internally very well-diversified and represent about 20% of the total capitalization of the U.S. market and 8% of total world market capitalization, according to Steven Adler, manager of ASM Index 30 Fund. However, appreciation-oriented investors still need to allocate their assets among different stock groups, including small companies and foreign issues. You never know which group is going to take the lead over the next decade. It's often a group that has lagged in the past, such as foreign stocks have done during most of the 1990s.

DOGS OF THE DOW

Several funds use Dow stocks in an active strategy. These funds don't seek to replicate the DJIA, but instead they try to outperform it.

Popularized by Michael O'Higgins in his 1991 book "Beating the Dow," the Dogs of the Dow is a simple strategy that has attracted attention during the 1990s because of its apparent potential to outperform the unmanaged Dow 30.

This contrarian approach is followed by Select Ten portfolios offered by Merrill Lynch, Smith Barney, PaineWebber, and other brokerage firms. The product was first offered in 1991 using a traditional unit investment trust format, and it has increased steadily in popularity. More than $10 billion was invested in all of the Select Ten trusts at this writing.

Among open-end mutual funds, a handful of newer Dow Dogs funds employ the strategy, although they do so with only a part of their assets because a mutual fund can't meet the IRS diversification requirements with its whole portfolio invested in the small number of stocks required in the strategy.

How does the Dow Dogs strategy work? Basically, equal investments are made at the start of each year in each of the 10 highest-yielding Dow 30 stocks, and the portfolio is revised a year later to again contain the 10 highest yielders. All 10 holdings are sold at the end of the year, even though some may qualify for inclusion next time around. This may lead to a tax burden for investors unless the strategy is used in a tax-deferred retirement account. To lessen the tax burden, some Select Ten portfolios offer a tax-lot accounting system. In theory, focusing on the highest-yielding stocks gets you to buy temporarily out-of-favor issues that possibly are oversold and underpriced.

Table 3 displays the annual total returns of the Dow Dogs strategy, the DJIA, and the S&P 500 over various periods based upon data provided by Merrill Lynch. The returns for the strategy are net of portfolio sales charges and expenses. The 16.09% return achieved by the Dow Dogs over the past 25 years compares very favorably with the 13.01% and 12.85% returns achieved by the Dow and S&P, respectively.

However, the strategy has fared poorly in recent periods, particularly in the last three years; perhaps its widespread popularity has diminished its potential gains. In addition, dividend yields have been at all-time lows in recent years, greatly reducing the contribution that yield makes to total return. The downtrend in yields on both the Dow and S&P 500 are evident in Figure 1.

Portfolio charges include a 1% upfront load and a 1.75% deferred sales charge. You don't pay the 1% initial charge if you subsequently roll your investment over into a new portfolio, but you continue to pay the 1.75% deferred sales charge. In addition, there is a 0.18% expense ratio. Even though these charges seem steep, Select Ten portfolios—with their low investment minimums—can be more economical for investors than buying and selling small lots of the individual stocks. However, you should be prepared to hold your Select Ten portfolio for at least the full year. If you sell before the termination, you still must pay the 1.75% deferred sales charge for the entire year as well as a charge associated with liquidating portfolio holdings.

If you decide this strategy is for you, the best alternative is probably to remain with it for a number of years to give it a chance to work. According to Merrill Lynch, more than 90% of Select Ten investors roll their portfolios over yearly. Dividends are paid quarterly; if you choose reinvestment, you can do so at a reduced sales charge. Net asset values of the Select Ten trusts are reported weekly in Barron's, appearing in a box titled "Defined Asset Funds."

Do you want to try the Dow Dogs strategy on your own? Several variations are possible. For instance, investors could limit themselves to using the five lowest-priced among the 10 highest-yielding Dow stocks. To benefit from the lower long-term capital gains rate in a taxable account, you could retain your stocks for 18 months and a day instead of a year. Of course, the portfolio should be rounded out with other investments for prudent diversification.

OTHER DOW MUTUAL FUNDS

Several no-load mutual funds mix Dow strategies in various ways. The recently launched Strong Dow 30 Value Fund invests 50% of its portfolio using a Dow 30 indexing approach and the other 50% based on the Dow Dogs strategy and other valuation factors.

Payden & Rygel Growth & Income invests half of its assets following a Dow Dogs strategy, and the balance is in the Amex-traded Spiders, which, as noted, track the S&P 500.

O'Shaughnessy Dogs of the Market allocates 30% to 50% of its assets to 10 Dow Dogs and the remainder to 30 to 40 large-cap stocks with similar qualities.

Finally, Hennessey Balanced invests half of its assets in the 10 highest-yielding Dow stocks and the remaining 50% in one-year Treasury bills. Neil Hennessey's objective is to provide a long-run return that's well above the Treasury bill rate with about half the volatility of a straight Dow index fund.

CONCLUDING THOUGHTS

The Dow is the oldest and most widely quoted barometer of U.S. stock market activity. A diverse, albeit small, group of Dow-oriented funds are now available. Diamonds offer a pure, economical index approach if you simply want to buy and hold the Dow, but you also want the liquidity of a stock and the ability to place limit orders to buy or sell at your target price.

The traditional Dow index mutual fund choices were limited at this writing, but you can expect to see at least a few more because of the average's popularity. In addition, more investors are recognizing that low-cost index funds beat most actively managed funds over extended periods.

Taking a very different tack, the Dow Dogs strategy is an enhanced approach that tries to beat the benchmark with its contrarian focus on high-yielding, out-of-favor blue chips. While the long-term results of this strategy are impressive, there is no assurance that it will continue to outperform the unmanaged Dow given the strategy's widespread popularity and the Dow's extremely low levels of dividend yields recently.

The purest version of the Dow Dogs is found with Select Ten unit investment trusts, but several mutual funds use the strategy with a portion of their assets. Each is unique and requires careful analysis of the prospectus, with special attention to costs.

Finally, don't buy the Dow feeling confident that it will continue to generate the dazzling returns it has during the bull markets of the 1980s and 1990s. The Dow returned 18.6% over the decade ended December 31, 1997, roughly 8 percentage points above the long-run historical average return on equities.

To avoid disappointments, be prepared to accept returns that are closer to—or even a bit below—the long-run average. ◆