BLUE-CHIP VALUE INVESTING: THE DOGS OF THE DOW

By Maria Crawford Scott

The purely mechanical nature of the approach forces strict investor discipline and requires no investment decision-making expertise—a highly appealing strategy to certain individual investors, particularly market newcomers.

Can a stock selection process that is simple and mechanical actually beat the market?

That's the appealing belief underlying the Dogs of the Dow approach.

The "dogs" are the stocks within the 30 Dow industrial average stocks that have the highest dividend yields (dividends divided by share price). The approach calls for equal investment in the highest-yielding stocks, with a total revamping of the portfolio once a year.

In theory, the approach takes advantage of the long-term positive returns associated with the market as defined by the Dow Jones industrial average, and adds a bonus by its selection of only the highest-yielding stocks. Higher-yielding stocks are often temporarily out-of-favor issues that are possibly underpriced. In addition to greater price appreciation potential, investors should benefit from higher dividend payments.

The purely mechanical nature of the approach also forces strict investor discipline, and requires no investment decision-making expertise—a highly appealing strategy to many individual investors, particularly market newcomers.

Although the appeal is to individuals managing their own stock portfolios, the popularity of the approach prompted development of a series of unit investment trusts offered by Merrill Lynch, Smith Barney, PaineWebber, and other brokerage firms; sales charges, however, are steep. In addition, a handful of mutual funds employ the strategy, although only with a part of their assets due to IRS diversification requirements.

The approach was popularized in the book "Beating the Dow" (paperback version published in 1992 by HarperPerennial, a division of HarperCollins; $14.00) by Michael O'Higgins, an investment advisor, and John Downes, a financial writer. Mr. Downes is now editor of the newsletter Beating the Dow (published by The Hirsch Organization; 201/767-4100; www.hirschorganization.com), an investment newsletter that continues to cover the theory. The book provides a basic outline of the approach, along with descriptions of each of the Dow stocks. This article is based primarily on the book.

THE PHILOSOPHY

The approach limits its universe to a highly select group of stocks—the 30 stocks that comprise the Dow Jones industrial average. These are large, well-known companies with immense financial resources and solid long-term track records that have weathered many economic storms. Their size and history provide these companies with a resilience that makes them relatively conservative investments. O'Higgins and Downes consider all of the Dow 30 to be strong long-term investments.

On the other hand, the investing public tends to overreact to unfavorable short-term developments and business cycles, and drives prices down to bargain levels. Considerable blame is placed on large institutional investors who dominate market trading and can thus cause sharp volatility. For individual investors, according to O'Higgins and Downes, this creates more

Maria Crawford Scott is editor of the AAII Journal.

opportunities than disadvantages, because they have greater flexibility to focus on the limited number of stocks in the approach.

The Dow Dogs approach proposes that individual investors emphasize Dow stocks that have been driven down by overreaction, since they will quickly regain a value that reflects the actual underlying risk.

What if stocks are cheap because the companies have real problems?

O'Higgins and Downes argue that the Dow stocks are so visible and widely analyzed that it is rare that surprises with major adverse financial implications occur. And surprises with big financial implications that have occurred in the past—the authors point to Union Carbide's Bhopal and Exxon's Valdez oil spill as examples—have been weathered in stride by the company, although stocks dropped temporarily providing a buying opportunity for contrarians. Even in the few worst-case instances of near-bankruptcies, Dow stocks historically have become turnaround situations, the authors note. The one exception: Manville Corp., a Dow stock until 1982 when it was forced into bankruptcy in the face of massive lawsuits.

According to the Dow Dogs approach, identifying undervalued Dow stocks is most effectively done by examining dividend yield—a company's current annual dividend per share divided by share price. It is similar to other popular valuation measures such as price-earnings ratios (price divided by earnings per share) and book value per share. However, price-earnings ratios and book value are subject to more distortion due to short-term earnings fluctuations as well as different accounting interpretations in book value and reported earnings. Dividend payments, in contrast, tend to be more predictable and not subject to differing accounting interpretations, offering a more stable measure to relate to share price.

THE DOGS OF THE DOW APPROACH

Philosophy and style

Dow Jones industrial average stocks are a select group of high-quality firms with strong financial positions and a long-term history of positive returns. These returns can be enhanced by picking the Dow stocks that are temporarily out-of-favor and possibly underpriced relative to the others, as indicated by high dividend yields. In addition to greater price appreciation potential, investors should benefit from higher dividend payments. The purely mechanical nature of the approach also forces strict investor discipline.

Universe of stocks

The 30 Dow Jones industrial average stocks.

Criteria for purchase

Dogs of the Dow:

- Select any starting day (the first trading day of the year is most common) and determine the 10 stocks of the 30 Dow Jones industrials that have the highest current dividend yield.
- Invest an equal dollar amount in each of those 10 stocks.

Five-Stock Dogs of the Dow Approach:

- Select any starting day (the first trading day of the year is most common) and determine the 10 stocks of the 30 Dow Jones industrials that have the highest current dividend yield.
- Once you have determined the 10 highest-yielding Dow stocks, identify the five of these with the lowest closing prices.
- Invest an equal dollar amount in each of the five stocks.

Portfolio monitoring and when to sell

Dogs of the Dow:

- Annually determine the total value of the portfolio, including all dividends and other cash distributions, along with the closing values of the stocks. Also determine the 10 stocks of the 30 Dow industrials with the highest current dividend yield. Sell all current holdings that have dropped off the list and replace them with new additions to the list. Rebalance the portfolio so that there is an equal dollar amount invested in each of the 10 holdings (each stock represents 10% of the value of the portfolio).

Five-Stock Dogs of the Dow Approach:

- Annually determine the total value of the portfolio, including all dividends and other cash distributions, along with the closing values of the stocks. Also determine the 10 stocks of the 30 Dow industrials with the highest current dividend yield and identify the five with the lowest price. Sell all current holdings that have dropped off the list and replace them with new additions to the list. Rebalance the portfolio so that there is an equal dollar amount invested in each of the five holdings (each stock represents 20% of the value of the portfolio).

Other factors

Taxes and transaction costs will substantially lower an investor's bottom-line return. Keep transaction costs low by using a low-cost discount broker. For taxable accounts, consider rebalancing after 18 months to take advantage of the lower long-term capital gains rates.

TABLE 1. DOGS OF THE DOW VS. THE DOW & S&P 500 (EXCLUDES TAXES AND TRANSACTION COSTS)

	Average Annual Returns*(%)		
	Dow Dogs	Dow 30	S&P 500
1930s	–1.04	2.23	–0.05
1940s	12.62	9.73	9.17
1950s	20.38	19.24	19.35
1960s	9.18	6.66	7.81
1970s	13.32	6.79	5.86
1980s	21.78	18.59	17.55
1990–97	19.45	16.83	16.57

**Returns exclude taxes and transaction costs, which would have a greater impact on the returns of the Dow Dogs approach.*

Source: "Stocks for the Long Run, 2nd edition" by Jeremy Siegel, McGraw Hill, 1998.

Over the short term, the prices of Dow stocks fluctuate with short-term earnings expectations, according to O'Higgins and Downes. This causes a company's dividend yield to fluctuate—when the dividend yield is relatively high, the share price has dropped relative to the dividend, usually because the market has doubts about the company's immediate earnings prospects. However, over the long term, the authors argue, prices for Dow stocks tend to be driven by dividends, since they are stable and have provided a considerable portion of an investor's long-term total return. Thus, dividend yields are brought back into line, and owners of the stocks benefit from both the price appreciation and the higher yields they received when they owned the stock.

The philosophy combines a strategy of investing in high-quality stocks with a contrarian approach.

THE MECHANICS

The traditional Dogs of the Dow dividend strategy is straightforward:

- Select any starting day (the first trading day of the year is most common) and determine the 10 stocks of the 30 Dow Jones industrials that have the highest current dividend yield. The stocks that make up the Dow industrial average are listed in The Wall Street Journal in the Dow Jones Averages summary graph. All are listed on the New York Stock Exchange, and dividend yields (as well as closing prices) for NYSE stocks are listed in the financial sections of most major newspapers, including The Wall Street Journal. Alternatively, you can calculate dividend yields by using the annual dividend for the 30 Dow stocks reported weekly in Barron's Market Laboratory section, and the closing prices for the 30 stocks on the chosen starting day.
- Invest an equal dollar amount in each of those 10 stocks.
- One year later, determine the total value of the portfolio, including all dividends and other cash distributions, along with the closing values of the stocks. Rebalance the portfolio by again investing an equal dollar amount in each of the 10 highest-yielding Dow Jones industrial stocks at this time. This means that stocks that have dropped off the top-10 yields list should be sold and replaced with new additions to the list. In addition, the amount invested in stocks remaining on the list should be only 10% of the value of the portfolio at this time, which may mean adding shares or selling shares from existing holdings.
- Repeat the process on each one-year anniversary date, and ignore the portfolio at all other times.

O'Higgins and Downes also suggest a more aggressive and selective five-stock approach:

- Select any starting day (the first trading day of the year is most common) and determine the 10 stocks of the 30 Dow Jones industrials that have the highest current dividend yield.
- Once you have determined the 10 highest-yielding Dow stocks, identify the five with the lowest closing prices, and invest an equal dollar amount in each of the five stocks.
- One year later, determine the total value of the portfolio, including all dividends and other cash distributions, along with the closing values of the stocks. Rebalance the portfolio by again investing an equal dollar amount in each of the five highest-yielding lowest-priced Dow Jones industrial stocks at this time—stocks that have dropped off the list should be sold and replaced with new additions, and the amount invested in stocks remaining on the list should be 20% of the value of the portfolio at this time, which may mean adding shares or selling shares from existing holdings.
- Repeat the process on each one-year anniversary date.

The five-stock approach is designed to take advantage of what O'Higgins and Downes argue is the tendency of less expensive stocks to be more prone to greater percentage price moves. They do point out, however, that such a portfolio lacks diversification, making it much more vulnerable to a major setback in one particular stock.

PORTFOLIO TURNOVER

The downside to the Dogs of the Dow approach is portfolio turnover, which will be higher due to the annual rebalancing requirement than

a strict buy-and-hold investment approach. O'Higgins and Downes report that in their simulations (covering 1973 to 1991), the 10-stock portfolio had turnover of about 30% to 40%, while the five-stock portfolio turnover rate was about 50%.

Portfolio turnover generates two major costs to an investor: transaction costs from the sale and purchase of stocks, and capital gains taxes if the portfolio is in a taxable account.

Transaction costs would vary based on the total amount being invested and the size of the trades that might be required to rebalance. Low-cost discount brokers can be used to help hold down these costs.

In addition, if the approach is in a taxable account, gains from any sales would be taxed at short-term capital gains rates (with a 28% maximum rate), since the lower long-term rates require an 18-month holding period. One possible adjustment to the approach would be to rebalance the portfolio after 18 months to take advantage of the lower capital gains rates. Nonetheless, any tax will adversely affect an investor's bottom-line return.

DOES IT WORK?

Numerous studies have appeared from both the academic and the investment community providing extensive data on the superior performance of the 10 top-yielding Dow Jones stocks over long time periods, although actual results from various studies differ depending on starting dates used and how dividend yields are defined.

Some recent studies suggest that the phenomenon may be playing out, perhaps a victim of its own success. Since high dividend yields reflect unpopularity, the more popular the Dogs of the Dow strategy becomes, the more likely it is that the stocks selected by the strategy will become overvalued [see, for example, "The Dow Dividend Strategy: Will History Continue to Repeat?" by Stephen E. Wilcox and Maros Cunderlik, in the October 1995 *AAII Journal*].

The strategy has fared poorly relative to the Dow average in the last three years. A contributing factor has been record-low dividend yields, greatly reducing the contribution that yield makes to total return.

On the other hand, the strategy has beaten the Dow 30, as well as the S&P 500, for the decade of the '90s (through 1997), as well as in every decade since the 1930s, according to Jeremy Siegel in his new edition of "Stocks for the Long Run." Table 1 summarizes his findings.

Whether the phenomenon will continue appears to be an open question. However, it is important to note that none of the studies take into consideration taxes and transaction costs, which would substantially reduce the returns to an individual investor relative to a buy-and-hold approach.

A SUMMARY K.I.S.

Keep It Simple (KIS) aptly summarizes the Dogs of the Dow approach.

It offers a purely mechanical approach that focuses exclusively on high-quality, well-known companies, and purchasing them when they become undervalued relative to each other.

The approach is particularly useful for individuals who prefer strict guidelines for buying and selling, who want a steady source of dividend income, and who lack the financial expertise required for more in-depth stock analysis. It is less useful for investors seeking primarily growth and who are trying to limit annual taxable income.

Is it too simplistic to handle the complexities of the investment arena? O'Higgins and Downes summarize their position best:

"The investment world has become complex to the point where analysis can be counterproductive. It's like a photograph blown up so you can see detail you never imagined—but where you can't recognize the faces.

"So it has become for the analysts trying and failing to predict corporate earnings, the economists divided on whether we are in recession or recovery, and the technical analysts trying to predict the direction of the markets, only to discover ever-new support and resistance levels.

"Sometimes the best way to read the weather is to stop studying the barometer and look out the window." ◆