CHARACTERISTICS OF DOGS OF THE DOW STOCKS

By John Bajkowski

The Dogs of the Dow approach takes advantage of the long-term positive returns associated with the market, and adds a contrarian bonus by focusing on only the highest-yielding stocks.

Few investment strategies have attracted the attention of such a diverse group of investors as that of the Dogs of the Dow approach. The "dogs" are the stocks within the 30 Dow Jones industrial average that have the highest dividend yields. The approach calls for equal investment in the 10 highest-yielding stocks, with a total revamping of the portfolio once a year.

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 adviser, 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. Maria Crawford Scott examined the Dogs of the Dow approach in the July 1998 issue of the *AAII Journal* and a summary of the approach from her article appears in Table 1. In this article, we will apply the Dogs of the Dow strategy and examine the dividend valuation levels of the stocks passing the screen.

DIVIDEND VALUATIONS

For mature dividend-paying companies, such as those that make up the Dow Jones industrial average, examining how the current dividend yield compares to past trends can provide a useful insight into value. Many investors turn to the dividend yield as a measure of value in their quest for underpriced securities. Like all basic value-oriented techniques, the dividend-yield strategy attempts to identify investments that are out-of-favor. Contrarian techniques such as this are based on the premise that markets tend to overreact to good and bad news and push the price of a security away from its intrinsic value. Value investors hope to identify these mispriced securities through the use of a consistent set of rules called a valuation model.

A stock's dividend yield is computed by taking the indicated dividend—the most recent quarterly dividend multiplied by four—and dividing it by the share price. Both the indicated dividend and the dividend yield can be found in publications such as the Wall Street Journal, Investor's Business Daily, Barron's, S&P's Stock Guide, and the Value Line Investment Survey. If a stock's price rises faster than its dividend, the yield may be low, indicating that the price may have been bid up too far and may be ready for a decline. Conversely, if the dividend yield is too high, the stock may be poised for an increase in price, if the dividend can be sustained.

Dividend yield analysis works best with larger capitalization companies that pay a meaningful dividend. These are typically mature firms that are not expanding greatly and do not need to plow all of their earnings back into the company. They can afford to pay a sizable dividend that attracts investors looking for a steady current income. When the yield is high, income investors will buy the stock, bidding up the price; when the yield is low, they will tend to exchange the shares for better-yielding securities—pushing the price down and thus the yield up. The trade-off for investing in dividend-rich firms is that

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these companies typically have more limited future growth opportunities.

DOGS OF THE DOW SCREEN

Table 2 lists the 10 Dow stocks with the highest dividend yields. *Stock Investor Professional* was used to perform the screen. First we created a screen that included only the 30 stocks in the Dow Jones industrial average. Then we ranked the companies by dividend yield and selected the top 10 yielding firms.

If you are doing the filter by hand, you could obtain a list of the stocks that make up the Dow Jones industrial average from the Dow Jones Averages summary graph within the Money and Investing Section of the Wall Street Journal. Since all of the Dow stocks are listed on the New York Stock Exchange, you can easily locate the closing price, dividend per share, and dividend yield for these stocks in the financial section of most major newspapers, including the Wall Street Journal.

BEYOND INDUSTRIALS

When working with the Dogs of the Dow it is important to understand that the Dow Jones industrial average is actually a diverse group of companies. Rather than a homogenous set of blue-chip companies, you will find companies of varying financial strength that compete in a wide range of industries, not all of which are industrial. One would expect to find old-line industrial firms such as Aluminum Company of America, Caterpillar, and Union Carbide Corporation. However, you will also find two oil and gas companies (Chevron and Exxon), three financial services companies (American Express, J.P. Morgan, and Travelers Group), two retail firms (Sears and Wal-Mart), and even Walt Disney, Coca-Cola and McDonald's. Technology is represented through Hewlett-Packard and IBM, while AT&T Corporation sits in for the communications group.

HISTORICAL NORM

While these stocks passed the Dogs of the Dow screen because of their high current dividend yield compared with other Dow stocks, a study of the company's own dividend yield history can be equally revealing. A current dividend yield higher than its historical average would be a sign that a stock is potentially undervalued. Models that examine historical averages assume that the growth prospects of the firm have not changed fundamentally over time and, based on historical relationships of dividends to price, the market is not correctly discounting the future potential of the firm.

The average dividend yield over the last five years is provided in Table 2 to help judge the normal dividend level for these stocks. While Philip Morris tops the Dow list with a 4.0% current dividend yield, the current yield is below its five-year average of 4.5%. Philip Morris's dividend yield averaged 5.4% in 1994 when its stock price dropped to about $15 on a split-adjusted basis. Only two of the stocks have current dividend yields higher than their historical averages—General Motors and Caterpillar. It is important to keep in mind that dividend yields for cyclical firms often creep up late in an economic cycle as investors start to fear the potential of an economic slowdown. Interna-

TABLE 1. 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

- 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.

Portfolio monitoring and when to sell

- 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).

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 2. DOGS OF THE DOW SCREENING RESULTS

Company (Exchange: Ticker)	Price ($)	Indicated Annual Dividend ($)	Current Dividend Yield (%)	Average Dividend Yield (5 Year) (%)	Current Industry Average Dividend Yield (%)	Historical Dividend Growth Rate (5 Year) (%)	Number of Dividend Increases Within Last 5 Years	Cash Dividend Paid Each Year Since	5-Year Growth Rate in EPS Histor'l (%)	5-Year Growth Rate in EPS Estim'd (%)	Payout Ratio (12 Mo.) (%)	52-Week Relative Strength Rank (%)
Philip Morris Cos. (N: MO)	40.25	1.60	4.0	4.5	2.1	15.5	5	1928	7.5	13.5	65.3	33
J.P. Morgan & Co. (N: JPM)	118.00	3.80	3.2	3.9	2.1	9.9	5	1892	-0.6	9.5	56.2	49
General Motors Corp. (N: GM)	68.88	2.00	2.9	2.4	0.8	7.4	4	1915	17.5	8.0	23.0	60
Chevron Corp. (N: CHV)	85.13	2.44	2.9	4.9	2.3	6.7	4	1912	16.6	8.0	52.6	53
3M (N: MMM)	82.25	2.20	2.7	2.9	1.7	5.8	4	1916	12.8	11.0	41.6	26
Eastman Kodak (N: EK)	73.31	1.76	2.4	2.9	0.6	–2.5	2	1902	–64.5	10.0	733.3	35
AT&T Corp. (N: T)	54.88	1.32	2.4	2.5	0.5	0.0	0	1881	4.7	10.0	44.1	81
Int'l Paper Co.(N: IP)	43.38	1.00	2.3	2.4	1.7	3.5	2	1946	–27.9	8.0	na	30
Exxon Corp. (N: XON)	72.88	1.64	2.3	3.9	2.3	2.8	2	1882	12.4	7.0	49.5	55
Caterpillar, Inc. (N: CAT)	54.13	1.20	2.2	1.7	0.5	44.7	4	1914	22.3	10.0	21.9	41
Dogs of the Dow Median			**2.6**	**2.9**	**—**	**6.3**	**—**		**10.0**	**9.8**	**49.5**	**—**
DJIA Median			**1.5**	**2.4**	**—**	**8.6**	**—**		**17.4**	**13.0**	**31.4**	**—**
All Stocks Median			**0.0**	**0.0**	**—**	**0.0**	**—**		**12.5**	**15.0**	**0.0**	**—**

Statistics are based on figures as of June 30, 1998.
Source: AAII's Stock Investor/Market Guide Inc. and I/B/E/S

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

tional business accounted for 51% of sales for Caterpillar, while it was just 23% of sales for General Motors. General Motors would especially be hurt by a domestic downturn.

INDUSTRY NORM

The diverse range of the Dow stocks exposes a potential weakness of the Dogs of the Dow screen. While all of the stocks are industry leaders, they operate in a wide range of industries with varying normal levels for dividend yields. Financials and established natural resource firms, for example, typically have higher dividends. The current industry average dividend yield is provided to help gauge how each company compares within its industry. With the exception of Exxon, all of the Dogs have dividend yields that exceed their current industry levels.

DIVIDEND HISTORY

For these stocks to succeed, the companies must perform well financially, and the market must take notice. Contrarian "bets" on widely followed stocks such as those that make up the Dow benefit from tremendous visibility. Increases in dividends and earnings will quickly translate into stock price increases.

A strong record of dividend increases is one sign of a company's commitment to supporting the stock price. Both Philip Morris and J.P. Morgan have increased dividends in each of the last five years. In contrast, AT&T passed through the last five years without a single dividend increase. The decade has seen AT&T go through a series of acquisitions and divestitures while looking for a proper mix for the future.

A simple statistic that has some meaning in judging the continuity of dividends is the number of consecutive years a cash dividend has been paid—a figure reported in the S&P Stock Guide. AT&T leads this group with a dividend payment made every year since 1881, a record few boards of directors would want to be responsible for breaking.

SAFETY OF THE DIVIDEND

Before a company can be considered a buy, the security of the dividend must also be examined. A high dividend yield may be a signal that the market expects the dividend to be cut shortly and has pushed down the price accordingly. Dividend payments are set by the board of directors, who go to great lengths to avoid lowering the indicated dividend. Decreasing or eliminating a dividend is tantamount to an announcement that the firm is financially distressed. While all of the Dow stocks are market-leading companies, a number of the cyclical firms such as General Motors and Caterpillar have a history of reduced dividend levels during economic slowdowns.

Earnings of companies in cyclical industries can vary greatly. To avoid constantly increasing and lowering the indicated dividend, some of these companies set a very low base dividend that they will have no trouble paying during the worst of times, and they pay "special" dividends during economic upturns.

Measures exist that help to identify the safety of the dividend. The payout ratio is perhaps the most common of these and is calculated

by dividing the dividend per share by earnings per share. Generally the lower the number, the more secure the dividend. Any ratio above 50% is considered a warning flag. However, for some industries, such as utilities, ratios around 80% are common. The current payout ratio for the Dow Jones utility group is 80.4%, versus 31.4% for the Dow Jones industrials. A 100% payout ratio indicates that a company is paying out all of its earnings in the form of dividends. International Paper shows an *na* for its payout ratio because of negative earnings. Eastman Kodak's pay out ratio of 733.3% indicates that its dividend is more than seven times its earnings. Firms cannot afford to pay out more than they earn in the long term.

EARNINGS STRENGTH

Profitability ultimately determines the ability of a firm to reward shareholders through both dividend payments and capital appreciation. The historical earnings growth rate provides an indication of past company performance, while the I/B/E/S consensus earnings growth rate estimate indicates the future expectations for these companies. Eastman Kodak shows the greatest swing, going from a negative annual growth rate of 64.5% to a positive expected growth of around 10% per year over the next five years. Eastman Kodak recently surprised Wall Street with even stronger than expected earnings, highlighting that even large stocks can have large price moves.

PRICE STRENGTH

The last column of data lists each company's relative price strength ranking, which compares the stock price performance over the last 52 weeks to that of all stocks. This percentile rank against all other firms ranges from a low of 1% to a high of 99%. A company with a relative strength rank of 25% outperformed one quarter of the firms tracked by *Stock Investor*, but underperformed three-quarters of the firms tracked. The higher the percentage rank, the better the relative strength.

Relative strength has grown in popularity as a stock selection tool as a number of research studies and successful investors have highlighted the benefit of seeking out stocks with high relative strength, especially when combined with other fundamental selection variables. The usefulness of relative strength is premised on the belief that positive relative strength against the market will continue.

Minnesota Mining & Manufacturing (3M) showed the weakest performance over the last year with a relative strength rank of 26%, while AT&T showed the strongest price strength with a rank of 81%. Investors should seek out not only strong relative strength, but also strong and improving relative strength. AT&T's strong price movement occurred in mid 1997, but its recent price strength is much weaker.

CONCLUSION

The Dogs of the Dow 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 through its selection of only the highest-yielding stocks. Higher-yielding stocks are often temporarily out-of-favor issues that are possibly underpriced. The Dow stocks are large firms that in the long term possess both the depth of management and the strength of resources to recover from any short-term stumbles. ✦

DEFINITIONS OF SCREENS AND TERMS

The following is a short description of the screens and terms used in Table 2.

Indicated Annual Dividend ($): The anticipated dividend per share payout over the next year. Computed by taking the most recent quarterly dividend and multiplying by four.

Current Dividend Yield (%): The indicated dividend divided by the current price. Provides a relative valuation measure when compared against other companies, historical levels, or industry norms.

Average Dividend Yield (%): The average company dividend yield during the last five years. Provides an indication of the normal valuation level for a company.

Current Industry Average Dividend Yield (%): The average current dividend yield for the industry in which a company competes. Provides an indication of the normal dividend level within an industry group.

Historical Dividend Growth Rate (%): The annual growth rate in dividends per share over the last five fiscal years.

Number of Dividend Increases Within the Last 5 Years: Number of years in which the dividend payout was increased over the last five years. Provides an indication of the company dividend payment policy with an emphasis on the frequency of dividend increases.

Cash Dividend Paid Each Year Since: The first year of the current string of years in which cash dividends have been paid.

5-Year Growth Rate in EPS—Historical (%): The annual growth rate in earnings per share over the last five fiscal years. A measure of how successful the firm has been in generating the bottom line, net profit.

5-Year Growth Rate in EPS—Estimated (%): The median growth rate in earnings per share from continuing operations over the next five years that is being forecasted by analysts as reported by I/B/E/S. An indication of the consensus in earnings growth expectations for the firm.

Payout Ratio (%): Dividends per share divided by earnings per share. Provides an indication of the safety of the dividend. Figures between 0% and 50% are considered safe.

52-Week Relative Strength Rank (%): The price performance of the stock during the last year compared to all other stocks. A figure of 75% indicates that the company outperformed 75% of all companies.