Chicago Tribune

Going to the dogs may be a winning strategy

By Spencer Jakab *January 14, 2007*

An investment strategy that has been derided by some money managers and academics as overly simplistic once again proved to be best in show last year.

The Dogs of the Dow strategy produced a capital gain of 26.6 percent in 2006 plus a dividend kick of 4.8 percent, handsomely beating the Dow Jones industrial average gain of 16.3 percent and yield of around 2.2 percent.

The strategy, popularized by Michael O'Higgins in his 1991 book "Beating the Dow," consists of simply buying the 10 highest-yielding dividend payers in the Dow, holding them for a year and then buying the new crop of dogs.

Proponents call it an easy way to handsomely outperform the average fund manager most years with an easy, do-it-yourself strategy. Critics call it an overly simplistic approach with hidden costs and risks that has outperformed only because of "data mining"--searching for statistical anomalies and then assuming they will work in the future.

"The starched shirt-and-suspender crowd in New York are pretty savvy, and it'll take a bit more to beat them than this," said finance professor Grant McQueen of Brigham Young University's Marriott School of Management. "It's a competitive world, and to think you'll get rewards without doing homework is naive."

McQueen and colleagues Steven Thorley and Kay Shields published a study 10 years ago that took a more sophisticated look at the Dogs of the Dow, pointing out some weaknesses.

A comparison of total returns for the 50 years leading up to 1995 for the Dogs compared to all 30 Dow stocks shows they outperformed on an outright basis--16.8 percent to 13.7 percent--but not when adjusted for the higher transaction costs, tax bite and the economic risk of holding a more concentrated portfolio.

The higher tax bite comes from taking short-term versus long-term capital gains and from realizing income as dividends versus buying stock in firms that are not big dividend payers, in which gains come in the form of capital appreciation and can be deferred. McQueen has not revisited the Dogs' performance since his study a decade ago but remains skeptical.

Proponents of the strategy only have to point to its past success, especially in the aftermath of the 1990s tech-stock bubble. Critics of simple investing rules counter that data mining can identify countless successful correlations that are spurious, for example, basing investing decisions on the victor of the Super Bowl or on the cycles of the moon.

Still, there might be a sound fundamental backing to the Dogs' outperformance. A study by Ned Davis Research concluded that stock in companies that pay dividends saw a total annualized return of 10.1 percent in the 33-year period ended in 2005 compared with a return of just 4.1

percent for stock in those that do not.

Dividend-paying stocks are typically value rather than growth companies, with low price-to-earnings ratios highly correlated with high dividend yields.

Value investors, a group including some of the fund managers with the best long-term performance records, have benefited from investors' tendency to overpay for growth and hence underpay for value.

Over the years a number of refinements have been suggested to the Dogs approach. Advocates have observed that the highest-yielding stock has typically been a real dog, while the second highest has historically done very well. Thus, avoiding No. 1 and overweighting No. 2 might enhance returns.

This would have backfired hugely the past two years, though, with GM starting as the top dog in 2006 and putting in the best performance of the entire index by rising 58.2 percent. In 2005 it was second on the list and had the index's worst performance, falling 51.5 percent.

Another proposed refinement has been to buy only the "little Dogs," or the top five. That would have been good in 2006, producing a capital gain of almost 36 percent, but disastrous in 2005, with a loss of nearly 11 percent. It would also concentrate portfolio risk among even fewer issues.

Yet another refinement, "Dow With Bonds"--this one suggested by a follow-up to O'Higgins' original book--has been to eschew the Dogs completely in years that Treasury yields exceed the earnings yield of the group by buying short-term issues when inflation is feared and longer-term ones when it's not.

For individual investors looking for a cheap way to possibly outperform the broader market in the long run, though, the Dogs strategy is not without its charms, and some of its weaknesses can be addressed.

For example, holding the Dogs in a tax-deferred account eliminates the disadvantage of realized gains, while holding them for one year and a day in taxable accounts reduces the hit. The lower tax rates on dividends also help.

As far as transaction costs go, buying and selling the 10 Dogs each year would not necessarily be pricier than a typical mutual fund's fees and, with typical discount brokerage commissions, might be less costly than even the cheapest index fund with a total investment of at least $120,000.

The Dogs of the Dow strategy consists of buying the 10 highest-yielding dividend payers in the Dow, holding them for a year and then buying the new crop of dogs. This year's dogs*:

General Motors Corp.
JPMorgan Chase & Co.
AT&T Inc.
Citigroup Inc.
Altria Group Inc.
DuPont Co.
Verizon Communications Inc.\
Pfizer Inc.
General Electric Co.
Merck & Co.

*Average dividend yield of 3.6 percent, down from 4.8 percent at the beginning of 2006