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New light on a classic strategy—the Dogs of the Dow

The most recent revisions to the tax law give investors a powerful incentive to seek out stocks in companies that pay generous dividends and which have the capacity to maintain their dividend payouts. Here we examine a stock selection strategy that has been around for years and has an excellent record for investment performance and safety, both historically and in real time: The Dogs of the Dow.

In a nutshell: buy high-yielding blue chip stocks

The "Dogs of the Dow" are the ten stocks out of the thirty in the Dow Jones Industrial Average that have the highest dividend yields. Implementing the Dogs of the Dow strategy consists of ranking all thirty companies in the Dow Industrials according to dividend yield using data from the last trading day of the year. Once that is accomplished, the portfolio consists of equal dollar amounts invested in each of the ten stocks with the highest dividend yields. (Dividend yield is the annual dividend payout of a stock divided by its price.) These ten stocks are held for the entire year. At the year's end, you select the ten new stocks from the Dow Industrials and rebalance your portfolio among these new Dogs, planning to hold them for the upcoming year.

Higher return and reduced risk from out-of-favor stocks

The system requires only a small amount of effort once each year. Yet it has outperformed the Dow Industrial Average over the long term, and has done so with less risk. Since 1957 the Dogs of the Dow have returned (including dividends) has returned a compounded average of 14.3%, compared to 11% for the Dow Industrials.

Moreover, not only have the Dogs of the Dow historically been more profitable than the entire Dow Industrials, they have also been safer. For example, during 2000-2002 the Dogs of the Dow strategy lost almost 8%, while the complete Dow Jones Industrial Average lost more than 23%. During the two years 1973-1974 the Dow Industrials lost 33%, while the Dogs of the Dow actually gained 2.6%. 1977 and 1981 were two more years in which the Dow Industrials lost while the Dogs gained. It is important to hold all or most of the indicated stocks when implementing this type of strategy because in the past individual stocks within the Dogs have frequently lost significant value.

Of course, this has not been a one-way street. In 1990, the Dogs lost almost 8% while the Dow Industrials lost under 1%. Furthermore, during many bull market periods the Dogs of the Dow strategy (along with other value stock strategies) has underperformed the broader market. The most recent stretch of Dog underperformance was the four years 1996-1999.

Note that none of the performance results above take into account taxes or transaction costs, nor slippage due to trading delays. Note also that until the relatively recent advent of the ETF linked

to the Dow Industrials—the Diamonds (DIA)—an economical investment in the basket of stocks that comprise the Dow Industrials was not available to individual investors. As with any investment strategy, past results do not predict any future level of performance or safety.

Why this has worked

Not all stocks with high dividends are good investments. Many are distressed companies that the market expects lack the wherewithal to continue their dividend payments. The trick in buying above-average dividend paying stocks is to weed out the genuinely distressed companies from those that are only temporarily down on their luck.

The theory behind the Dogs of the Dow strategy is the assumption that the committee that selects companies for inclusion in the Dow Jones Industrial Average selected only companies that are fundamentally sound enough remain in business and that will continue to earn enough to maintain their dividend payouts over the long term. (The only company in the Dow Industrials ever to go bankrupt was Johns Manville.) An investor in the Dogs is implicitly betting that the market has priced these Dog stocks too low, so that they will outperform the market in future years as their "true" worth becomes apparent to the investment community.

Current Dogs of the Dow selections

For those of you interested in starting a portfolio from scratch, the current ten components of the Dow Industrials with the highest yields (as of July 18, 2003) are Eastman Kodak, Altria, General Motors, SBC Communications, AT&T, JP Morgan Chase, DuPont, Citigroup, ExxonMobil and General Electric. The average dividend yield of these ten is currently 4.2%, compared to a yield of only 2.2% for the entire Dow Industrials.

For further information

There are three sources of information about the strategy discussed here that I have found very useful and easy to read. First are the books by Michael O'Higgins (*Beating the Dow*—written in 1991, the book discusses the 10-stock strategy described here and variations using fewer stocks; *Beating the Dow with Bonds*—written in 1999, which uses only a five-stock strategy, along with long Treasury bonds and T-bills). O'Higgins' books have a lot of detail about the component stocks in the Dow Jones Industrial Average, as well as historical performance back to 1973. Second is the website www.dogsofthedow.com. The website has up-to-date information about the recent performance of the strategy and the most recent tallies of the top ten dividend yielding stocks in the Dow Industrials. The best risk/reward analysis of the Dogs of the Dow strategy, and also the best long term performance history, has been published by Dr. Mark Vakkur in Stocks and Commodities magazine (1997) and is also available on his website www.vakkur.com.

Next steps

Implementing the Dogs of the Dow strategy is probably best accomplished through a discount broker. You should pay close attention to the impact of commissions and possible slippage on your total investment, aiming to keep these costs to ½% of your investment or lower. As an

example, if you can execute trades for $10, you need to spend $100 to buy all ten Dogs. If you want to limit your transaction costs to ½%, a minimum investment of $20,000 would be required. If you have less than that much to invest, you might be better off with a low-expense large cap value portfolio such as the Russell 1000 Value iShare (IWD) or the Vanguard Value Index Fund (VIVAX). There are a number of unit trusts and the like that implement the Dogs of the Dow strategy, but the ones with which I have been familiar impose such high expenses and/or sales charges as to nullify the potential benefits of this strategy.

Technical analysts among you might put together the list of Dogs, but instead of buying them all as close as possible to the year's close, refine the timing of your purchases by analyzing the charts of the ten stocks you are looking to buy.