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FEATURE

Groomed for a Comeback

By JONATHAN R. LAING

Chevron, Wal-Mart, Kraft and other promising new Dogs of the Dow could bring some bite back to this investment strategy. Video: Let the Dogs In

THE DOGS OF THE DOW INVESTMENT STRATEGY sounds great in theory. It advocates buying the 10 highest-yielding stocks among the 30 industrials at the beginning of each year, holding them until the start of the following year and then starting the process anew.



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John Kuczala for *Barron's*

Some of the less obedient Dogs look ready to act like champs again.

That way, an investor can presumably fatten his dividend returns, thereby building a substantial buffer against any market downturns, while also acquiring solid blue-chip stocks that are cheap by virtue of being temporarily out of favor. The Dogs' yields, of course, wouldn't be so fat if the stocks weren't so beaten down in value.

THE DOGS STRATEGY was promulgated by a money manager named Michael O'Higgins in his 1991 best-seller *Beating the Dow*, based on back-testing of the Dogs' performance over several decades. And for a time in the mid-1990s, the strategy continued to work.

But then came the tech bubble of 1997 through 1999, during which the stodgy Dogs of the Dow got smoked -- not only by the then-technology-heavy Standard & Poor's 500, but also by the 30 stocks in the Dow Jones Industrial Average.

And while the Dogs provided some protection in the 2000-02 bear market against the slide in both the S&P and the Dow, the strategy's performance has been mediocre since. For example, in the baleful market downturn in 2008, the Dogs did even worse, falling 38.8%, compared with the 37% and 31.93% declines in the S&P and Dow, respectively. Moreover, the Dogs badly trailed both indexes in the turnaround year of 2009, delivering a positive total return of just 17.8%, compared with 26.46% jump in the S&P and a 22.68% gain for the Dow 30.

Table: [A Really Mixed Showing](#)

This disappointing two-year skein was largely the result of

dividend eliminations and the stock collapses of **American International Group** (ticker: AIG), **Citigroup** (C) and General Motors in 2008, and a flurry of dividend cuts in the 2009 Dogs. So much for the supposed defensive and cheap-valuation advantages afforded by the Dogs of the Dow.

As a result, the Dogs have shown a compound annual return over the past 15 years (1995 through 2009) of 7.57%, compared with the S&P's 8.04% and the Dow 30 Industrials' 9.20%.

Yet all mightn't be lost for the strategy, despite the Dogs' difficulties in recent years. After all, during that decade-and-a-half, they beat the S&P in six years and tied it once, and outstripped the Dow seven times and tied it once. (The table Judging the Dogs illustrates the year-by-year performance.)

The good news for fans of the Dogs theory is that, with the economy seemingly on the mend, the hazard of dividend cuts and the collapse of once-venerable Dow names has receded somewhat.

Table: Judging the Dogs

In addition, the roster of Dow Dogs for 2010 looks quite strong, even if some of the names -- say **General Electric** (GE) and **Pfizer** (PFE) -- have struggled mightily and somewhat unsuccessfully to recover their former magic. The list provides nice exposure to quality oil companies **ExxonMobil** (XOM) and **Chevron** (CVX), the aggressive global retail giant **Wal-Mart** (WMT) and longtime consumer-product icon Procter & Gamble (PG). Telecom giants **Verizon** (VZ) and **AT&T** (T) likewise appear to be deftly navigating the transition from land lines to mobile telephony and other digital-delivery systems. And then there's **Kraft** (KFT), now trying to take over **Cadbury** (CBY). The fact that Warren Buffett is a current 9% holder is an unimpeachable indication of Kraft's undervaluation. Rounding out the Dog portfolio is **McDonald's** (MCD), a pre-eminent global brand.

ONE INVESTOR WHO IS SANGUINE about the 2010 Dogs is, unsurprisingly, Neil Hennessy, proprietor of the **Hennessy Balanced** (HBF BX) and **Hennessy Total Return** (HDOGX) funds, which include weightings of 50% and 75% in the Dogs. The remainders of the funds' portfolios are invested in Treasury securities that mature in a year or less. Redemptions and disappointing performance have driven down the funds' assets under management to around \$70 million total, less than half of their peak size three years ago.

Hennessy insists the Dogs could have plenty of bite this year, being cheap and of high quality. He expects that many of the companies on the current list will consider boosting their dividend to push their stocks higher.

"Companies of this quality have gone through tough restructurings to cut costs, hoard cash, reduce debt and hive off underperforming operations," he adds. "As a result, much of any revenue growth will drop to the bottom line."

To be sure, the Dogs have disappointed of late. But, of course, the best time to embrace a strategy is when it has fallen into disfavor. And if Hennessy is right, the latest Dogs of the Dow are poised to perform like Westminster Kennel Club show dogs, rather than a bunch of mutts.

E-mail comments to editors@barrons.com

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