



Dividends

Dogs could have their day in 2011

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Michael O'Higgins is the first to admit that the Dogs of the Dow strategy has fallen on hard times as a stock-picking technique.

"I'd say it's very unpopular right now," he said. "In the investment world, if something hasn't worked for a year or two, they damn it."

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Mr. O'Higgins, head of O'Higgins Asset Management of Miami Beach, Fla., is the man who popularized the strategy with his 1991 book *Beating The Dow*. In it, he recommended investors buy the Dow's dogs – the 10 highest-yielding dividend stocks in the blue-chip index – at the end of each year and hold them for the next 12 months.

The strategy hasn't worked in recent years. But contrarian investors who shy away from trendy ideas and hot stocks may want to take a fresh look at the Dogs of the Dow now that it has fallen so far out of favour.

The Dogs of the Dow strategy was particularly hard hit in 2008 and 2009 because of the failure of one of its key tenets – that Dow companies, which represent the backbone of the U.S. economy, don't cut their dividends.

That bedrock belief was smashed during the worst days of the financial crisis. General Motors Corp. suspended its dividend in 2008, before filing for bankruptcy protection the following year. General Electric Co. lopped off about two-thirds of its dividend in 2009.

Once-mighty financials slashed their dividends, to zero in the case of Citigroup Inc. Even Pfizer

Inc., the highly profitable pharmaceutical company, sliced its dividend in half in 2009 to help finance a \$68-billion (U.S.) deal to acquire Wyeth.

As a result of the cuts, the Dogs of the Dow plunged 39 per cent in 2008, a sharper dive than the broader market. The strategy staged a comeback in 2009 with a 17 per cent gain, but it still lagged the broader market.

Now dividends are rebounding in popularity as financial stability has returned. According to Standard & Poor's, within the S&P 500 there were 251 dividend increases in 2010, up from just 157 last year – and decreases shrank to just four this year from 78 last year.

On the surface, stability should bode well for the Dogs of the Dow if investors grow less concerned about the threat of dividend cuts. However, Howard Silverblatt, senior index analyst at Standard & Poor's, believes investors might not have the same interest in high-yielding stocks as they once did.

“Investors are a lot more careful,” Mr. Silverblatt said. “They are looking at cash flow. They are looking at companies with more safety – better dividend-coverage ratios. So buying the highest-yielding stocks is not always the best idea.”

As well, dividend-investing strategies ignore the importance of share buybacks, or repurchases – an alternative method of returning cash to shareholders that some companies prefer.

“When companies pay dividends, there seems to be this expectation among market participants that the dividends are going to keep coming, absent some financial catastrophe for the firm,” said Michael Roberts, a finance professor at the Wharton School of the University of Pennsylvania. “Whereas repurchases afford firms a much greater deal of flexibility for returning cash, both in terms of magnitude and timing.”

Skeptics point to the mixed track record for the Dogs of the Dow. The strategy walloped its benchmarks in 2002 and 2006, but lagged during most other years this decade. In the past five years and 10 years, the Dogs gained 9 per cent and 25 per cent, respectively, beating the S&P 500 during both periods but slightly trailing the Dow.

For Mr. O' Higgins, though, the doubts feed into the strategy's contrarian appeal.

“This is a strategy that is based on buying unpopular stocks,” he said. “So if the entire strategy is unpopular, you have a kind of double positive.”

Certainly, the ideas behind the Dogs of the Dow are appealing. As a passive strategy, it encourages investors to become less emotional in their stock-picking, ignoring some of the short-term news that might be driving stock prices down. (Dividend yields are often high because stock prices have fallen.)

The strategy also recognizes that dividends are essential components to investment portfolios,

contributing about half the gains.

Right now, dividends hold extra appeal. With 10-year Canadian and U.S. government bonds yielding just over 3 per cent, the 3.9 per cent average yield on the Dogs of the Dow looks attractive for income-seeking investors.

What's more, a number of strategists have been pointing out that high-quality, defensive stocks with international exposure – the prime roaming grounds for the Dogs – have been virtually ignored as investors charge into higher-risk names. This makes the Dogs look like good buying opportunities.

David Rosenberg, the famously bearish chief economist and strategist at Gluskin Sheff, said recently that he favours undervalued non-cyclical companies with consistent dividend growth. Stephen Jarislowsky of Jarislowsky Fraser, and Jeremy Grantham of asset manager GMO LLC, have expressed similar views.

If they're right, the Dogs of the Dow might be ready to run in 2011.

HOW THE DOGS DID

2010 Dogs, with year-to-date returns (including dividends) and current yield:

AT&T Inc., +10.2 per cent; yield 5.8 per cent

Verizon Communications Inc., +20.2 per cent; yield 5.6 per cent

DuPont, +54.1 per cent; yield 3.3 per cent

Kraft Foods Inc., +20.7 per cent; yield 3.6 per cent

Merck & Co. Inc., +3.3 per cent; yield 4.2 per cent

Chevron Corp., +21.1 per cent; yield 3.2 per cent

McDonald's Corp., +27.3 per cent; yield 3.2 per cent

Pfizer Inc., -0.6 per cent; yield 4.6 per cent

Home Depot Inc., +25.4 per cent; yield 2.7 per cent

Boeing Co., +22.7 per cent; yield 2.6 per cent

EXPECTED CHANGES TO 2011 DOGS

Home Depot Inc.: Out

Boeing Co.: Out

Intel Corp: In (yield: 3.4 per cent)

Johnson & Johnson: In (yield: 3.5 per cent)