

FINANCIAL POST

Dogs of Dow look good for 2008

By David Berman

Saturday, December 15, 2007

After turning in its most impressive performance of the past 10 years in 2006, it seems only natural that the Dogs of the Dow investment strategy would have a bumper year this year -- a possible sign that the strategy is gearing up for a rip-roaring performance in 2008.

The strategy, an attractively simple one that entails buying the 10 highest-yielding stocks on the Dow Jones industrial average at the start of each year and holding the stocks for 12 months, is not exactly causing its subscribers sleepless nights: It is up 4.5% this year after dividends are factored in.

But with just two weeks left in the year, the Dogs have half the total return of the Dow, whereas the strategy usually outdoes the Dow in any given year: It trounced the blue-chip index with a 30% return last year.

Rather than a statistical quirk or a hint that maybe the strategy no longer works, the lagging Dogs speak volumes about the stock market in 2007 and could provide a hint or two about 2008.

The strategy is appealing because it forces investors to buy the most beaten-up companies on the index, since high yields tend to reflect soft share prices (as shares go down, yields rise as long as dividends are not slashed). The beauty about Dow member-companies is that, despite occasional setbacks, the odds of an outright bankruptcy are slim since these companies tend to be multinational giants. In other words, beaten-up Dow stocks bounce back.

(over)

The problem with 2007 is that the 10 Dogs have been held back by a triple-whammy of bad news. General Motors Corp. (down 14%, year-to-date) continues to struggle through a restructuring, Pfizer Inc. (down 11%) has endured setbacks in its pipeline of new drugs and competitive threats from generic drug makers, and Citigroup Inc. (down 45%) has been hammered by write-downs associated with U.S. subprime mortgages.

These are big problems that are currently weighing on stocks. But the beautiful part about the Dogs of the Dow theory is that it takes away the temptation among investors to overreact to their fears and miss out on buying opportunities. Indeed, it directs you toward your fears.

"There's always something," said Michael O'Higgins of O'Higgins Asset Management, the man who popularized the Dogs of the Dow. "The problem is that people can't quantify the problem, so they step aside. Those of us who have the courage to jump into the abyss get paid."

This courage has not paid off in 2007, but only because some Dogs, especially the financials, were hit hard mid-way through the year. This means that next year's Dogs, which are likely to bear a strong resemblance to the 2007 names, look especially attractive.

On a valuation basis, these stocks are trading at just 15-times trailing earnings, versus 18.3-times trailing earnings for the S&P 500. And they yield 3.7%, versus a yield of 2% for the S&P 500. From a contrarian's perspective, the Dogs have rarely looked better.
