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Tax Plan Throws a Bone to the 'Dogs of the Dow'

by RICHARD TEITELBAUM

Tax-free stock dividends? Sure, Wall Street likes the idea, but the prospect has one breed of stock pickers virtually yelping for joy.

That group, the followers of the "Dogs of the Dow" strategy, stands to reap handsomely if the Bush administration's proposal to eliminate taxes on most dividend income becomes law. That is because the strategy leads investors to high-yielding stocks: payouts would be worth more if they escaped the government's tithe, and the dividend-paying shares themselves would likely receive a boost if investors flocked to them.

"We have here a possible change in taxes that will lead to a sea change in investor thinking," said Francis D. Gannon, manager of the SunAmerica Focused Dividend Strategy Portfolio, which uses the strategy to pick about one-third of its holdings. "I think there's an enormous opportunity."

Popularized by Michael B. O'Higgins in "Beating the Dow" (HarperBusiness, 1991), the strategy in its classic form calls for buying the 10 highest-yielding stocks in the Dow Jones industrial average, called Dogs, because their prices tend to be beaten down. The shares are bought in equal dollar amounts on Jan. 1 and held through year-end. Then the process repeats, with the investor rebalancing the portfolio among an updated roster of the 10 top-yielding Dow stocks. The strategy was the rage for much of the 1990's, but fell out of favor in the technology bubble as investors flocked to growth stocks that paid no dividends, and has yet to regain its popularity.

Dogsofthedow.com, a Web site that tracks the strategy, identifies the Dogs this year as Philip Morris, J. P. Morgan Chase, General Motors, Eastman Kodak, SBC Communications, DuPont, Honeywell International, General Electric, Caterpillar and AT&T. They were yielding an average of 4.20 percent on Dec. 31, versus 2.47 percent for the Dow industrials. (There are different ways to calculate yield, so the roster may vary.)

Whatever the impact of rescinding the dividend tax on the overall market, some portfolio managers say the move would prompt a substantially bigger gain in the Dogs. Christopher N. Orndorff, a managing

principal at Payden & Rygel, a money management firm, estimated that even a 50 percent reduction in the tax would send the Dogs up 10 to 15 percent in just a few months and 20 percent or more over 12 months. "This thing has happened rather quickly," Mr. Orndorff said of the proposed dividend tax elimination. "I don't think they have fully priced it in yet."

Of course, he added, other factors could quickly reduce potential gains. "If we have a fall-off in corporate earnings, the dividend tax cut won't matter much at all," said Mr. Orndorff, who uses the Dogs strategy in helping to manage the Payden Growth and Income fund.

Still, proponents contend that the Dog stocks are benefiting from a variety of factors and are a good bet regardless of the final disposition of the dividend tax. Given that 10-year Treasury notes yield just 4 percent or so, investors have the luxury of earning bond market yields on their stock holdings even without a tax advantage, said Neil J. Hennessy, president of the Hennessy Funds, which runs two small portfolios, Balanced and Total Return, that use the strategy. That kind of yield parity, he said, does not occur often.

Mr. Hennessy said the Dogs could lead the market based on their own merits. "Investor confidence is growing with these companies, since they have the money to pay their dividends," he said. "They've taken their write-offs, they've laid off people, they're lean now, and earnings are going to surprise people over the next 12 to 18 months."

High-yielding stocks are likely to become more popular, he added, as baby boomers enter retirement and begin searching for income-producing investments.

The strategy generally outperforms down markets or those that tilt toward value stocks, because it directs investors to some of the most downtrodden stocks in the index. So Charles B. Carlson, chief executive of Horizon Investment Services, a money management firm in Hammond, Ind., said it would be unlikely to win in a rollicking growth market.

The Dogs have indeed been on a run, at least when compared with the broader market. According to dogsofthedow.com, the Dogs beat the Dow average in each of the last three years. In 2000, the Dogs returned 6.4 percent,

versus a loss of 4.7 percent for the index. In 2001, the Dogs lost 4.9 percent, still better than the 5.4 percent loss for the benchmark. And last year, the Dogs were down 8.9 percent, versus a decline of 15 percent for the index.

(For the 10-year period ended Dec. 31, the Dogs underperformed, returning 12.8 percent, annualized, versus 13.3 percent for the broader index.)

The Dogs of the Dow is not the only stock-picking strategy that could benefit from the elimination of the dividend tax. Mr. Gannon said investors could seek out companies that currently do not pay dividends but may change their policies; such shifts would likely cause those stocks to climb. Characteristics to look for are generous cash flows, large amounts of cash on the balance sheet and low debt. Mr. Gannon cites Microsoft (the only stock in the Dow industrials not to pay a dividend), Cisco Systems and Dell Computer as three likely candidates. Last year, Cisco shareholders rejected a proposal to institute a dividend.

Playing the Dogs requires making some choices. Diversification requirements prohibit mutual funds from investing more than 5 percent of their total assets in a single stock, so funds that use the strategy generally marry it to another investing discipline. Some unit investment trusts — fixed, unmanaged pools of securities with a set life span — are pure plays on the Dogs and are sold by many brokerage firms. Even with loads and expenses, these can be cheaper for many investors than buying individual stocks.

Mr. O'Higgins, meanwhile, who runs a money management firm in Miami Beach, said he still believed the Dogs strategy would beat the Dow index over the long term. But he has turned bearish with a vengeance, and his firm now holds gold and Treasury securities and is short the Dow, the Standard & Poor's 500-stock index and the Nasdaq 100.

Despite the bursting of the technology bubble and the subsequent bear market, Mr. O'Higgins said he believed investors were still wildly overoptimistic. "People haven't sold, mutual fund managers haven't raised cash, and the brokerage firms haven't reduced their equity allocations," he said. "It was the greatest mania of all time and will be followed by the greatest depression of all time."