

Should you let sleeping dogs lie?

Tried and true stock-picking method not so true right now

By James Kim and Matt Krantz, USA TODAY

Dogs were once in vogue on Wall Street.

The Dogs of the Dow Jones industrial average that is. These stocks were once popular among "value" investors. But now the method, which calls for people to buy the 10 stocks with the highest dividends compared with their stock prices, is almost forgotten. The theory's main proponent has moved on. Investors have shunned various Dog-related investment products. And the pundits proclaim, Bill Murray-style: These dogs don't hunt.

Over the last two years, Dog investors would have sorely underperformed the Dow, the Standard & Poor's 500 and other popular indexes. In fact, investors would have fared better by doing the opposite of the Dog. By investing in the Stars of the Dow, those with the lowest dividend yields, investors would have beaten the S&P 500 last year and come close to matching the Dow.

Some experts note that two years really isn't enough time to discredit the Dogs theory. Still, even if temporary, the breakdown of the theory says a lot about the modern market. Dividends and yields, once considered solid indicators of a stock's value, are out. Growth and "momentum" investing, meanwhile, are in, as more investors pile into no-dividends, no-earnings companies.

"I don't pay attention to (dividends) any more," says Victor Miller, 77, a retired resident of Muskegon, Mich. "About three or four years ago, I stopped thinking about them. What do they give you? A few pennies a share. That's not a heck of a lot. I would rather go with growth. Growth beats dividends."

What's a dog?

The Dogs of the Dow strategy is built on the assumption that a high dividend yield signals a good stock bargain. The theory: Whatever has weighed the stocks down, thereby boosting their dividend yield, is a temporary problem. So you can buy low, and then eventually the stocks will rally. The Stars of the Dow, which have the lowest yields, have had the best performance -- and have the momentum that now attracts so many investors on Wall Street.

Miller, who typifies the modern investor in many ways, owns highfliers such as Qualcomm and JDS Uniphase. And he's planning to buy more. He's betting on them, despite the fact that neither pays dividends and both sport triple-digit price-to-revenue ratios.

As for the Dogs, Miller's not about to buy them.

Dog theory

The theory is simple: At the end of each year, investors buy shares of the 10 stocks in the Dow that have the highest dividend yield, or stock price divided by annual dividend paid. These are supposed to be high-quality stocks that are temporarily out of favor, or so the thinking goes.

Computer back-testing showed that the method, made popular by money manager Michael O'Higgins in his 1992 book, *Beating the Dow*, would have worked for decades. In fact, the Dogs have returned an annual average 17.7% since 1973 vs. the Dow's 11.9%, according to the Web site Dogsofthedow.com.

1999's Dogs and how they've done so far this year:

- ▶ DuPont, -21.5%
- ▶ Caterpillar, -19.9%
- ▶ Goodyear, -15.8%
- ▶ Philip Morris, -14.7%
- ▶ JP Morgan, -13.6%
- ▶ Chevron, -12.0%
- ▶ **Dow average, -11.1%**
- ▶ 3M, -10.5%
- ▶ Eastman Kodak, -8.9%
- ▶ Exxon Mobil, -6.9%
- ▶ General Motors, 1.1%

In the mid-1990s, the theory spawned a thriving cottage industry, replete with mutual funds, unit investment trusts and, ultimately, Web sites. A host of variations on the Dog theme, all discovered via computer back-testing, also sprouted. Populist Web sites such as the Motley Fool became ardent supporters.

The method was predicated on the assumption that out-of-favor, undervalued stocks would be discovered by Wall Street. And the smart money would eventually bid those stocks up.

But the method has hit a bump recently.

Last year, Dogs investors would have lost 2.4% of their investment vs. a 25% gain for the index. In 1998, they would have only gained 9.5%, trailing the 16% return of the Dow. The last time the Dogs theory even came close to holding up was 1997, when Doggies gained 20.4% vs. 22.6% for the Dow.

The Breakdown of the Dogs theory reflects some key changes in the stock market:

▶ **Dividends don't matter.** While professional investors bicker over whether value investing will return, it's pretty much agreed that the days of using

dividends as a gauge of good investments are over and unlikely ever to return.

"This is just not an appealing option for investment growth anymore," says Eugene Peroni, director of equity research for Nuveen Investments.

Kenneth Lee, author of *Trouncing the Dow*, says, "Dividends mattered a lot more in the 1980s than the 1990s." He notes that many of the new Dow stocks -- there have been eight changes in the last three years -- don't have dividends, such as Microsoft.

Citing academic research, Mark Hulbert of Hulbert Financial Digest notes only 21% of companies now offer dividends vs. 67% in 1978.

An obvious reason, he says, is that there are so many start-ups, new small-capitalization emerging-growth companies that pay no dividends.

► **Value investing is passé, for now.** The average growth stock mutual fund last year returned 40.1% vs. the 6.8% return of value funds, Morningstar says. That's an ever bigger spread than in 1998, when growth funds returned 22.1% vs. value fund's 5.9%.

At Nuveen Investments, investors have been moving money out of Nuveen Investment's unit trust based on the Dogs of the Dow, and putting it into unit investment trusts chock full of growth stocks, Peroni says.

One of the most popular replacements is the Peroni Top Ten Picks unit investment trust, which contains soaring tech stocks such as EMC, Macromedia, Philips and Sun Microsystems. "I don't know that value is completely dismissed, but there clearly is focus on momentum," he says.

A similar rotation is occurring among Merrill Lynch clients. Many are moving out of the investment bank's Select 10 unit investment trust, based on the Dogs of the Dow theory, and into the firm's growth-oriented trusts, says Timothy Mahoney, chief investment officer of deferred asset funds. "People have clearly chosen growth," he says.

To underscore the extent to which investors are piling into winners, turn the Dogs of the Dow theory on its head. Instead of buying the beat-up stocks, what if an investor bought the 10 lowest-yielding stocks?

The Stars method would have worked fine the last two years. In 1999, the Stars, as calculated by Global Financial Data, returned 22.4% on the investment vs. a small loss for the Dogs. In 1998, the stars rose 17.5% vs. the Dogs' 9.4%.

Time heals all

On Wall Street, of course, nothing lasts forever.

In one year, the Dogs could -- some say will -- roar back, leaving momentum investors bruised. Hulbert notes that two years of underperformance is really not enough time to discredit the Dogs theory.

Peroni is not giving up on value investing. He says momentum investing, like any fad, will run its course when investors look for bargains. But in the meantime, he doesn't want to bet against what is working.

Chris Orndorff, head of equity at Payden & Rygel Mutual Funds, which offers a fund based in part on the Dogs of the Dow, is also hopeful that value investing will return. "Momentum investing is a temporary phase that could end in five years," he says.

"If value is dead, a lot of skilled investors are wrong," he says. "Value will come back."

Momentum and value rotate in and out of favor with investors every three to five years, says Charles Rother, analyst at American Strategic Capital. And the shift can be violent: "Stocks that have been bid to high valuations by momentum investors drop

90% when value returns," Rother says. "And they don't come back."

Dogs' creator O'Higgins suspects the Dogs of the Dow theory may start working again by the end of the year, provided that 2000 is a bear market. (That could very well turn out to be the case: The Dow is off 11% for 2000 and nearly 13% from its high.)

"People are tired of the Dogs of the Dow," he says. "That's usually the signal it will come back."

Retired investor Miller understands that stocks can fall as fast as they rise. "Down the line, I may have to put some of my money in CDs," he says. But for now, he's comfortable holding Qualcomm and JDS Uniphase.

In fact, he's waiting for the right moment to buy more.

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