Hennessy Fund Beats Peers by Sticking to `Dogs of Dow' Strategy

By Matthew Keenan

Sept. 21 (Bloomberg) -- Neil Hennessy, the last remaining mutual-fund manager to follow the so-called Dogs of the Dow strategy, is producing market-beating returns by investing in Merck & Co., AT&T Inc. and General Motors Corp.

The $104 million Hennessy Total Return Fund owns shares of 10 companies that have been the worst performers on the Dow Jones Industrial Average over 12 months and pay the highest dividends. Hennessy's top ``dogs'' include drugmaker Merck and long-distance phone company AT&T. Both stocks climbed more than 38 percent in the past year.

``This is boring, but it makes money over time,'' Hennessy, 50, said in an interview from his office in Novato, California.

His fund gained 18 percent in the past year, its largest advance since 2003, to rank first of 126 large-company value funds tracked by Bloomberg. The Dow climbed 13 percent in the same period, including reinvested dividends, and the average large-cap value fund 4.9 percent.

The dogs approach gained attention after investor Michael O'Higgins published the book ``Beating the Dow'' in 1991. O'Higgins wrote that investors could make money without doing research by simply buying the worst-performing stocks that pay above-average dividends. At least five money managers, including Los Angeles-based Payden & Rygel, started funds to mimic the idea by the end of the decade.

The strategy started to falter in the late 1990s when Internet and computer-related companies soared in value. After the technology bubble burst in 2000, many investors shifted money to shares of smaller ``value'' companies, which are cheap relative to financial yardsticks such as earnings.

Abandoning the Dogs

The $58 million Payden Value Leaders Fund dropped the dogs strategy last November because it was too unpredictable compared with investing in broader groups of value stocks, said Kimberly Tipton, a spokeswoman for Payden & Rygel.

Hennessy's approach ``certainly isn't a magic thing that will automatically help you beat the market,'' said David Kathman, an analyst for Morningstar Inc. The Chicago-based research firm gives the Hennessy fund a two-star rating, its second-lowest ranking.

Hennessy invests 75 percent of his fund's net assets in the 10 highest-yielding Dow stocks and 25 percent in U.S. Treasuries that mature in less than a year. He buys the dogs in equal dollar amounts each month and, in effect, runs 12 mini-portfolios that hold the stocks for a year. Then he sells shares to reallocate the proceeds among the Dow's 10 new dogs.

The fund has a Sharpe ratio of 0.74, less than the 1.24 average for large-company value funds, according to Morningstar. While a higher Sharpe ratio indicates better risk-adjusted performance, the Hennessy fund's ratio is lower than its peers because of its Treasury market investments.

Trailing Small-Caps

The Dow climbed at an average annual rate of 11 percent from 2003 to 2005, half as much as the Russell 2000 Index, a benchmark for small-cap stocks. Dow stocks are now more attractive as investors are seeking stability, Hennessy said. In addition, the dogs strategy is easy to understand and offers less risk in declining markets, he said.

``Maybe you don't have the most spectacular returns, but you still have your money,'' he said. The fund fell a

cumulative 1.6 percent in the 2000-to-2002 bear market while the Dow lost 23 percent of its value.

A former stockbroker, Hennessy is president of Hennessy Advisors Inc., a publicly traded firm that oversees $2.1 billion in assets. Mostly owned by Hennessy, his family and officials at the firm, Hennessy Advisors went public in 2002, and its shares have climbed at an average annual rate of 52 percent, easily outperforming his fund.

Basketball Scholarship

Hennessy attended the University of San Diego on a basketball scholarship in 1974, playing guard and later serving as an assistant coach for the school's team, the Toreros. He left San Diego before completing his studies and later persuaded the school to allow him to take three remaining courses, ultimately receiving his bachelor's degree in business administration in 2004.

``I wanted my degree from there,'' he said. ``And just as with the dogs of the Dow, I was very patient.''

Merck, AT&T and General Motors have buoyed the fund in the past year. Merck, the fourth-largest U.S. drugmaker, is expected by analysts to increase profit this year after four years of declines. The company, based in Whitehouse Station, New Jersey, raised its 2006 forecasts twice this year, sending its total return up 36 percent.

San Antonio-based AT&T was created by the merger of SBC Communications Inc. and AT&T Corp. last November. Helped by its Cingular Wireless unit, the largest U.S. telephone company will increase earnings per share by 57 percent this year, analysts estimate. The stock has returned 35 percent in 2006.

Sweet Dividends

The fund's largest stock holding, Detroit-based General Motors, has jumped 68 percent this year after dropping a total of 58 percent in 2005 and 2004. Rick Wagoner, chief executive officer of the world's largest car maker, is in talks with Carlos Ghosn, head of Renault SA and Nissan Motor Co., about forming a three-way alliance to reverse the company's shrinking market share.

For Hennessy, the companies' dividends sweeten gains and cushion price declines. Merck pays a 3.6 percent dividend yield, AT&T 4.2 percent and GM 3.2 percent. On average, Dow companies pay 2.2 percent.

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