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THE DOW'S DOGS WON'T HUNT

A POPULAR INVESTMENT THEORY HAS RUN ITS COURSE

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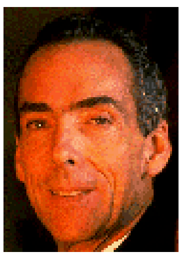

"Dogs" star O'Higgins now likes bonds

Seven years ago, Michael O'Higgins, a successful if inconspicuous money manager, thrilled the investment world with a simple formula for generating superior returns: Buy the dogs. He discovered that if you buy the 10 stocks among the Dow 30 with the highest yields (dividend divided by price) and updated the portfolio once a year, the returns would triple those posted by the Dow Jones industrial average over the previous two decades. O'Higgins' 1991 book, Beating the Dow, was an instant hit and spawned a cultlike following. There are two Websites, three mutual funds, dozens of Unit Investment Trusts (UITs) and untold thousands of personal accounts leashed to the dogs. In all, probably more than $20 billion is invested in his strategy. And, uh, by the way, it doesn't work.

Midway through last week, the Dow 10 had returned 16.9% this year, vs. 22.9% for the Dow. The high yielders underperformed in two of the three previous years as well. Say it ain't so, Mike. But he won't. In fact, he's one of the first to note that his dogs of the Dow--so named because high yields signal out-of-favor stocks--"have become too popular and the market has become too high" for the gambit to keep working. O'Higgins is now writing another book and next month will launch a mutual fund on a different scheme through Valley Forge Funds (888-600-4537). This one has him 100% in bonds.

Dow-dog lovers aren't taking this kick in the rear without a yelp. "I don't think the model is threatened," says Tom Gardner, co-founder of the Motley Fool Website, where an estimated 200,000 "fools" play some version of the Dow dogs. Stan Craig, head of UIT sales at Merrill Lynch (which controls $10 billion in Dow-dog assets), notes that a buy-and-hold investor in the first "Select 10" UIT in 1991 would be up 184% by now, vs. 171% for the Dow. But clearly the advantages first noted by O'Higgins have eroded. Morningstar Inc. studied the strategy over the 24 years ending in 1996. It found that the first half of the period--before anyone really used this approach--produced almost all of the outperformance: 15.4% annually for the Dow dogs, vs. 6.5% for the Dow in the first 12 years; 18.9% vs. 18.2% in the second 12 years.

And that brings me to O'Higgins' new strategy: beating the Dow with bonds. O'Higgins sold all his stocks in 1993--missing some great years. For most of that time, though, he was invested in 30-year zero-coupon Treasury bonds, which also did well. This year, for example, zeros are up 23.4%. You know zero about zeros? They are basically bonds whose accrued principal and interest are paid at the end of the term. The bonds are safe if held to maturity, but their trading price whipsaws depending on interest-rate trends. For example, Treasury bonds now yield about 6%. If the yield declines to 5%, the price of a zero goes up 25% whereas the price of a traditional bond would go up only half as much. Right now the trend is toward lower rates. O'Higgins plans to ride the trend with zeros for at least another year. Such market timing is fraught with risk. But then so is riding a sky-high stock market. If beating the Dow is your pet cause, give this new dog a look. The old one may be lovable, but it doesn't hunt the way it used to.

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