Classic ‘dogs of the Dow’ investment strategy is crushing the market this year

OCTOBER 18, 2016 | ***Alex Rosenberg, NBR, CNBC.com***

A classic investment strategy has paid dividends this year — literally.

The “dogs of the Dow” strategy, popularized by Michael O’Higgins in his 1991 book “Beating the Dow,” entails buying the 10 Dow stocks with the highest dividend yields (which tend to be investment “dogs,” given that rising yields tend to be functions of falling prices) and holding on to them for a year.

At the end of 2015, the list of the highest-yielding stocks was topped byVerizon and Chevron; Caterpillar, Exxon Mobil and IBM round out the top five. Together, these stocks have generated an average total return of 18.3 percent through Monday’s close, according to a CNBC analysis of FactSet data. Add in 2015’s next-highest-yielding quintet, and the classic strategy has yielded a gain of 14 percent this year.

This compares to an average total return of 6.4 percent for all 30 Dow stocks. (Note that this differs from the performance of the actual Dow Jones industrial average since this includes dividends while the index return does not, and this assumes equal weighting while the Dow is price-weighted.)

Translation: Investors who have chased the “dogs” this year have done more than twice as well as their less canine-enthused competitors.

To be sure, the Dow dogs have collectively been big beneficiaries of this year’s drop in bond yields, which has made buying high-dividend stocks an increasingly attractive options for income seekers.

“If you look back at this year, the strategy probably performed well because a lot of the bond-related investments performed well as rates were falling through the first half of the year,” Oppenheimer chief technical analyst Ari Wald said Monday on CNBC’s “Trading Nation.”

Yet looking forward, with yields heading higher due to inflationary pressures and the prospect of at least one Federal Reserve rate hike in the next few months, “we don’t see this as an attractive strategy because stocks that pay high dividends tend to come under pressure in a rising interest rate environment,” Wald warned.

For Kevin Caron, a market strategist with Stifel Nicolaus advisory affiliate Washington Crossing Advisors, the strategy of simply buying those stocks with the highest dividend yields is a bit too narrow-sighted.

Not only does the “dogs of the Dow” strategy not consider share repurchases, which are functionally equivalent, but a high dividend yield “could mean a lot of things — it could mean more risk, it could mean not a lot of growth — so I wouldn’t put all my eggs in that basket for sure,” Caron said on “Trading Nation.”

Indeed, to Wald’s and Caron’s points, assuming that a sole criterion can hold the key to outperforming the market in all environments seems silly on its face.

At the same time, those who have pursued the strategy this year might consider sending Mr. O’Higgins a “thank you” note.