The Dogs of the Dow
An Old Dog With a New Bite
The Dogs of the Dow: A Look Back

The “Dogs of the Dow” strategy was introduced to the investment world in 1991 with a remarkably simple approach: buy the 10 highest-yielding stocks in the 30-stock Dow Jones Industrial Average as of December 31st of each calendar year. By following this process, investors would buy mature companies, household names with ample cash to return to shareholders. In the 30 years or so since its introduction, and despite an impressive record, the strategy has attracted some criticism. Some pundits viewed it as limited, providing only a dividend yield, but not total return. Others saw it as just too simple. But in an ever-complex market environment, and as our works shows, simple is sometimes better.

The Dogs of the Dow is a straightforward, contrarian strategy that has delivered not just higher yields, but more consistent returns.¹ We witnessed this phenomenon as recently as last year when the 10-stock Dogs of the Dow once again outperformed the S&P 500 Index. The 2015 class (stocks meeting the criteria as of December 31, 2014) saw the 10 Dogs of the Dow deliver a total return of +2.6% compared with +1.4% for the S&P 500 Index (see Exhibit 1). Leading the way were two well-known but often criticized blue-chip American companies: McDonalds (MCD), up 29.8% and General Electric (GE), up 26.9%. Despite starkly different businesses, these two U.S. mega-caps nonetheless were subject to similar criticisms: slow growth, outdated business models, and entrenched managements, products and strategies. But in 2015, contrary to expectations, both companies addressed such shortcomings with revised business models, divestitures and new products. Most importantly, the market responded favorably to the changes and the stocks went on to outperform the market.

Last year was no fluke. In fact, the Dogs of the Dow has outpaced the S&P 500 by more than 2% per year since 2000, and has outperformed in four of the last six years of the post-Great Recession period.² Winners in recent years include E.I. du Pont (DD) in 2010, up 54%, more than tripling the S&P 500 return, Hewlett Packard (HPQ) in 2013, which more than doubled for the year—three times the gain of the S&P 500, and Intel (INTC), up 44% in 2014, as compared with the 13.5% return of the S&P 500.

¹ FactSet Portfolio Analytics
² Dogsofthedow.com as of 12/31/15

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A Time-Tested Theory and Approach

The Dogs of the Dow strategy was originally conceived in the book entitled, “Beating the Dow: A High Return, Low Risk Method for Investing in the Dow Industrial Stocks with as Little as $5,000”, by money manager Michael B. O’Higgins (with John Downs). Higgins theorized that investing in the 10 highest-yielding stocks on the 30-stock Dow Jones Industrial Average, regardless of the relative fundamental merits of those 10 stocks, would deliver superior returns. Indeed, back-testing results going back to 1920 put forth in the book supported his theory.

The strategy ran counter to two strong prevailing trends at the time:

1) A principle of modern portfolio theory in which diversified portfolios can deliver better returns over the long run and with lower risk than concentrated strategies, such as the Dogs of the Dow

2) The growing trend toward in-house research—both sell side and buy—in which consistent, well-founded, fundamental stock research was preferential to blind stock-picking toolsets

Even so, the theory was popularized in the press and elsewhere. Fledging young cold-calling brokers honed their marketing skills utilizing the Dogs of the Dow strategy. Some we have talked to attest to the success of the effort, which included talking up the likes of JPMorgan (JPM), Texaco, and 3M Company (MMM) in a single portfolio, a fruitful tactic for opening new accounts.

The attraction to these types of stocks was understandable. While growth rates have typically been lower and margins on par with the broad market, these mature companies feature more attractive valuations, higher dividends and greater cash flow than the rest of the market.

The Dogs’ mature business models and strong cash flow help drive another valuable aspect of this strategy: risk mitigation. In periods when the market has fallen, these attributes have enabled the Dogs to post small declines. Case in point, from 1997 to 1999, the Dogs couldn’t keep pace with high-flying technology stocks. Then from 2000 to 2003, as the economy went into recession and the stock market retreated, the Dogs of the Dow lost less value than the S&P 500. While there is no guarantee that this phenomenon will repeat itself in every market cycle, during that period, the Dogs effectively erased the underperformance they had generated during the previous three years.

Long-term historical performance and risk mitigation help support the value-based approach of the Dogs of the Dow
The Increasing Focus on Dividends

Unlike the 1990s technology boom when many stocks soared to new highs based on projected rather than actual earnings, today, the largest companies in the U.S. are generating impressive amounts of cash flow. In fact, Corporate America as a whole is awash in approximately $2 trillion in cash and liquid assets on their balance sheets. Armed with cash, companies have engaged in prolific share buybacks as well as transformative mergers and acquisitions. Impressively, 2015 marked the highest-ever level of global M&A activity by dollar volume.³

The Dogs have been leading the charge on deploying this cash. In 2015 alone, two Dogs of the Dow acquired other large companies: AT&T (T) bought DirectTV, and Verizon (VZ) purchased AOL. Others, such as General Electric, aggressively divested businesses to create shareholder value. In shedding its finance arm, GE closed over $110 billion in transactions, which will help finance $35 billion in dividends.⁴

But buybacks and acquisitions are still not enough to completely sop up companies’ excess capital. Since the large cash hordes at these mega-cap U.S. companies cannot be left alone, corporate leaders are turning to dividends. From 1994 to 2012, dividend payout ratios declined to approximately 30%. That meant that for every dollar a company earned, nearly one-third was being used to pay shareholder dividends. Since 2012, that number has been steadily climbing to a current level of about 40%. This is still well below the longer-term average from 1952-1994 of 50%, suggesting that dividends could climb even higher.

As companies have raised their payout ratios and directed more of their earnings towards dividends, dividend yields have risen too. Leading up to the financial crisis, the 10 Dogs of the Dow had an average dividend yield of 3.3%. Since the financial crisis, that number has risen to 4.2%. Meanwhile, the yield for the S&P 500 has averaged just 2.1% since the crisis (see Exhibit 2).

Today’s Dogs Are Changing

All this corporate change comes amidst a concerted effort by the index owners, S&P Dow Jones Indices, to diversify away from the traditional heavy industrial nature of the overall 30-stock Dow Jones Industrial Average to a more dynamic index. Recent changes include the 2009 dumping of General Motors (GM) and Citigroup (C) in favor of Travelers (TRV) and Cisco (CSCO), the 2013 swapping of Alcoa (AA), Bank of America (BAC) and Hewlett Packard (HP) for Goldman Sachs (GS), Nike (NKE) and Visa (V). This was followed by perhaps the most telling change of all in 2015 in which AT&T was taken out of the Dow, and Apple (AAPL) was added.

The 2016 version of the Dogs of the Dow offers several changes. Leaving the list are General Electric, McDonalds, AT&T and Coca-Cola (KO). New entrants are IBM (IBM), Proctor & Gamble (PG), Walmart (WMT) and Cisco. The yields of the current 10 stocks range from a low of 3.1% (Cisco) to a high of 4.8% (Verizon), while the average of the 10 sits at 3.9%. AT&T fell out by virtue of its March 2015 drop from the Dow Jones Industrial Average. Its replacement, Apple, with a yield of 1.8%, ranks 27th in yield of the 30 Dow stocks and so does not make the Dogs list. GE, McDonald’s and Coca-Cola dropped out of the Dogs given price increases, dropping their yields below the #10 ranking. Staying are Merck (MRK), Pfizer, Verizon, Chevron (CVX), Caterpillar (CAT) and Exxon (XOM).

While the selection process remains the same, it has been interesting to see how the composition of companies has changed over the years. It wasn’t long ago that Microsoft was thought of as the quintessential growth stock devoid of a dividend payout. After being added to the Dow in 1999, Microsoft declared its first dividend in 2003. Then, 10 years later, Microsoft achieved Dogs of the Dow status, with its yield ranking among the ten-highest in the index. Fast forward to 2012 when Apple declared its first dividend and subsequently in March 2015, the tech leader was named to the Dow Jones Index. With its current yield of 1.8%, Apple is a far cry from Dogs status, but that could change. Given Apple’s large cash balances, modest earnings growth expectations and absence from the M&A marketplace, it’s possible that a higher dividend payout ratio from the quintessential growth stock of our times could push its yield to Dogs of the Dow-levels.

The largest companies in America have approximately $2 trillion in cash and liquid assets on their balance sheets

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5 Dogsofthedow.com as of 12/31/15

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Leveraging the Dogs

Harnessing the Power of the Yield + Growth Potential

The Dogs of the Dow is a simple approach to identifying the highest-yielding 10 stocks of the 30 in the Dow Jones Industrial Average. Yet, behind that are some powerful investment tenets for today’s market. First, these stocks currently offer a dividend yield of nearly 4%, a very attractive figure given the continued low interest rate environment. In addition, buying these types of well-established cash-generating companies may provide some level of volatility management. With escalated market volatility during the first quarter of 2016, the value-based approach and regular income stream may help to lessen price swings relative to the rest of the equity market. And lastly, the Dogs’ lower valuations may mean that the market is underappreciating their potential. The tables seemed to have turned on the growth-dominated environments that have lingered since the 2007-2008 financial crisis, and this shift could help pave the way for today’s Dogs to outperform in the long-term.
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Timothy Pettee is Senior Vice President and Chief Investment Strategist at SunAmerica Asset Management, with more than 30 years of investment experience. Prior to joining SunAmerica, Mr. Pettee was Executive Vice President and Global Director of Research for Schroder Investment Management. He was also Director of Research with U.S. Trust Company of New York and co-managed that firm’s small-cap retail funds and research core products. He previously held several positions in research and portfolio management at Alliance Capital Management.

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For more information about this whitepaper or SunAmerica Mutual Funds, please call 800-232-1230 or visit www.safunds.com.
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