Michael Brush

To print article, click **Print** on your browser's **File** menu.

[Go back](#)

Posted 11/9/2005

Company Focus

5 Dow dogs about to have their days

The traditional Dogs of the Dow theory no longer works, so here's a better way. Track down giants like Wal-Mart and Home Depot that are snapping up their own stock.

By [Michael Brush](#)

As the end of the year draws near, it won't be long before market pundits trot out a familiar old investing strategy.

Known as the Dogs of the Dow, it directs investors to load up on the 10 stocks in the **Dow Jones Industrial Average** ([$INDU](#)) with the highest dividend yields at the start of a new year.

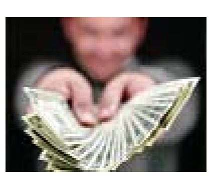
Buying the Dow dogs puts you in relatively safe value names that are supposed to come back. They are beaten down, which is why they have the highest dividend yields. But it's only temporary because, after all, you are buying tried and true companies. Otherwise, they wouldn't be in the Dow.

In practice, however, these dogs don't hunt.

As of mid-October, for example, this year's 10 dogs -- which include really sick pups like **General Motors** ([GM](#), [news](#), [msgs](#)) and **Verizon** ([VZ](#), [news](#), [msgs](#)) -- had taken a 13% bite out of adherents' portfolios in 2005, calculates Morningstar analyst Jim Callahan. In contrast, the **S&P 500** ([$INX](#)) lost 2%.

The strategy has lagged the market in recent years, as well. In the 10 years leading up to the end of 2004, Dow dogs gained 12.9% compared to 14% for the S&P 500.

Related news and commentary on MSN Money



- [Hate Big Oil? Hate home-builders, too](#)
- [Wal-Mart's pricey gamble](#)
- [3 myths put Home Depot, Lowe's in a fix](#)
- [General Motors' big scam](#)

Cool Tools

[Get market news by e-mail](#)

[See if refinancing works](#)

[Personal finance bookshelf](#)

Find It!
[Article Index](#)
[Finance Q&A](#)
[Tools Index](#)
[Site map](#)

msn Money

Company Focus

Recent articles:
- [Hop on board another China growth play](#), 11/2/2005
- [Internet IPOs: Zombie dot-coms rise again](#) , 10/26/2005
- [On the front lines of the flu fight](#), 10/19/2005

[More...](#)

A breed apart

At least one money manager, however, has taught an old dog new tricks -- modifying the classic Dogs of the Dow tactic so that it beats the market by a long shot.

The fix, from David Fried of The Buyback Letter, is simple: He uses buybacks instead.

Since 1997, Fried's "Buyback Dogs" has posted total gains of 174% as of the end of September. In the same time, the S&P 500 advanced 53.2% and the Dow Jones Industrial Average was up 52%. The Dogs of the Dow gained about 43%.

To find his buyback dogs, Fried takes the 10 Dow stocks with the biggest net decline in number of shares outstanding compared to the year-ago number. From that group, he takes the five with the lowest price-to-sales ratio.

Fried's approach probably works so well because it basically lets you practice value investing along with some of the brainiest people in the business world -- the managers of the 30 companies in the Dow.

"When these companies buy back shares, you've got really the best and the brightest saying their stock is undervalued," says Fried. "It doesn't get much better than that as far as good, legal, inside information is concerned."

Fried's current buyback dogs are: **Wal-Mart Stores** (WMT, news, msgs), **Home Depot** (HD, news, msgs), **ExxonMobil** (XOM, news, msgs), **American Express** (AXP, news, msgs) and **International Business Machines** (IBM, news, msgs).

They share three basic qualities.

- First, of course, they are all buying back lots of stock. The share count at IBM declined by 5.1% in the most recent quarter, while Wal-Mart, Home Depot and ExxonMobil saw declines in the 1.9%-to-2.5% range. The share count at American Express contracted 1.1%.

- These stocks look cheap relative to their historic trading range and the rest of the Dow. Fried's buyback dogs trade for a price-to-sales ratio of 1.3, compared to 2.1 for the Dow.

- Most of these companies suffer from some misperception that is holding them back, or some problem that looks solvable.

Here is a closer look.

Wal-Mart

Wal-Mart is the Rodney Dangerfield of retailers. Even though it helped save U.S. families $2,329 last year on average -- according to a Wal-Mart-funded study, anyway -- the discount chain gets no respect.

Activists regularly smear the retailer for alleged abuses of workers and the environment. A "Fahrenheit 9/11"-style documentary called "Wal-Mart: The High Cost of Low Prices" piles on with the same charges this month. Even the low-brow comedy site JibJab Media has a satirical cartoon clip tweaking a thinly disguised Wal-Mart for eliminating the jobs of U.S. factory workers -- one of whom winds up cleaning toilets at a sprawling big-box retail chain.

Video: Wal-Mart documentary roundtable, JibJab clip and more

The negative sentiment helps explain why Wal-Mart stock has been marked down to $48, from $58 a year ago.

But Wal-Mart's stock won’t always be this cheap. The retailer’s scale still provides huge leverage over suppliers. That’s now helping Wal-Mart’s campaign to move into the grocery business, where it can undercut competitors by up to 20%, says Morningstar analyst Joseph Beaulieu.

And despite opposition from activists, Wal-Mart plans to open 1,400 new locations, which will add to its 5,000 stores around the globe.

Beaulieu believes the retailer is already coming out of its slump, citing impressive 10.7% sales growth last quarter. "We remain confident that the shares are significantly undervalued," says Beaulieu. Fried says the surest evidence is that Wal-Mart -- whose managers wrote the book on purchasing at bargain prices -- has been buying back its own stock.

Home Depot

With interest rates rising, many investors worry that a slowdown in the housing market will be bad for Home Depot. Higher gasoline prices seem ominous, too. What’s more, Home Depot has built so many stores it may have saturated its markets, while **Lowe’s** (LOW, news, msgs) is a formidable competitor.

All these apparent obstacles help explain why Home Depot stock has gone nowhere this year. "Home Depot is just undervalued," says Fried. The stock trades for 13.9 times forward earnings, well below its three-year historical average price-earnings multiple of 15.9.

Yet Home Depot’s fundamentals are among the strongest in the group, with earnings expected to grow from 14% to 17% this year. Where is that growth coming from? First off, management says that historically higher interest rates don’t hurt business. And with real incomes rising as fast as they have in 30 years, higher fuel costs aren’t such a concern, either.

Meanwhile, Home Depot is garnering robust growth from "do-it-for-me" installation services and new lines of business catering to professional contractors. "The market is saying Home Depot is mature, but I don’t think their growth is over by a long shot," says Fried. "And that is what their buybacks are telling us."

Like other big retailers, Home Depot has centralized purchasing, which gives it better leverage over suppliers. That’s helped to boost return on capital to 22.2% this year compared to 21% last year, says CIBC World Markets analyst Dan Wewer. He thinks the stock could rise to $49 in a year from recent levels of around $41.

ExxonMobil

ExxonMobil's profits of $26 billion last year on $290 billion in revenue were the biggest ever at a public company. Many investors wonder how it can continue to grow.

The trick is disciplined use of capital, which Chief Executive Lee Raymond describes as "boringly consistent." This highly conservative approach to spending is one reason the energy behemoth regularly posts returns on investment that handily best those of its peers, says Morningstar analyst Mark Uptigrove.

CNBC Video: ExxonMobil CEO testifies at Senate hearing and more

ExxonMobil notched an impressive 33% increase in earnings for the third quarter in part because of higher oil prices -- another worry among some investors now that the price of crude is bubbling down. Since late September, ExxonMobil stock has retreated to $58 from $64.

But Uptigrove doesn’t believe further softness in oil will hurt long-term investors in this stock. He says ExxonMobil's "unrelenting pursuit of operational efficiency" gives it an edge no matter what energy prices do.

To offset a presence in mature fields in North America and Europe, ExxonMobil has positioned itself in more long-lived oilfields in West Africa, the Middle East and Russia. The company is also building out a vast global network to supply natural gas.

Oppenheimer energy sector analyst Fadel Gheit agrees the recent correction in energy stocks like ExxonMobil creates a good buying opportunity for long-term investors.

American Express

American Express, of course, caters to higher income consumers who spend lots of money. The benefits of this strategy were clear once again in the credit card giant’s most recent quarterly results. Net income jumped 23%, thanks to an 18% increase in spending on Amex cards. That increase came from a 12% jump in spending per card and a 9% increase in the number of Amex cards in circulation.

Since Amex cardholders open up their wallets more often, Amex has the power to charge merchants a premium rate -- or about 2.6% of every transaction compared to around 1.6% charged by competitors like Visa and MasterCard.

Amex has also begun issuing co-branded cards with other credit-card companies like **MBNA** (KRB, news, msgs). So far, this approach shows promise. "We think these types of partnerships will provide earnings growth with little invested capital – a dream scenario," says Morningstar analyst Ryan Batchelor. CIBC World Markets analyst Meredith Whitney has a $62 price target on American Express shares. The stock recently traded for $49.50.

IBM

A weak first quarter sent IBM shares tumbling below $75 last April from above $95 earlier in the year. But recently, analysts have been bumping up estimates as several lines of business are perking up. The stock has responded, moving off its lows of last April. But more gains are likely next year, say analysts, as several positive trends continue to unfold.

IBM’s information technology services group -- which contributes about half of revenue -- has been closing deals that slipped earlier this year, building up a backlog. A new product cycle in IBM’s mainframe business should support earnings growth in 2006, says Chris Whitmore of Deutsche Bank Securities. And later this month, **Microsoft's** (MSFT, news, msgs) new Xbox 360 console will be launched in the U.S. IBM designed chips used in the new console.

Restructuring at IBM, meanwhile, has cut overhead by more than 4%. That should contribute to a "significant" improvement in earnings into 2006 as sales pick up, says Whitmore. He has a price target of $100 on the stock. IBM shares recently traded for $83.

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.