Investing

Buy Into a New Breed of Dow Dogs

By Michael Brush

RealMoney.com Contributor

3/12/2007 7:13 AM EDT

URL: http://www.thestreet.com/p/rmoney/investing/10343578.html

Listen up, dog lovers, this pullback is giving you a great opportunity to load up on your favorite dogs of the **Dow**.

After all, the Dow Jones Industrial Average stocks are survivors. They'll make it through any turbulence the economy throws at them, according to the popular investing strategy. So you should buy 'em when they are down.

But unlike most Dow dog fans, I wouldn't bring home just any ol' down-and-out pooch. I'd go for Dow dogs with a different pedigree: the Dow companies with the biggest share buyback plans in place.

This can offer much better results than the classic Dow dogs approach, which seeks out the most battered names, or those sporting the highest dividend yields. How much better does a "buyback dogs" strategy work?

Money manager and newsletter author David Fried runs a Buyback Dogs portfolio for his managed accounts. According to Fried, his buyback dogs have returned 221% since 1998. That's far better than the 75% return for the **S&P 500** over the same period, or the 67% an investor using the traditional Dow dogs portfolio strategy would have reaped.

The Ultimate Insider Money

Why has this variant left the original strategy behind with the lapdogs?

It's because adherents are practicing value investing alongside corporate managers who are so good at what they do they're the top dogs in their fields: managers in the exclusive club of the 30 Dow industrials.

"It's the ultimate insider money, the collective insider," says Fried. "You've got the best and the brightest saying their stock is undervalued."

Fried keeps just five pooches in his Buyback Dogs portfolio at any given moment. He doesn't rebalance every quarter, every December or in any regular pattern at all. Instead, he calculates the intensity of share buybacks at Dow companies every quarter when fresh information comes out. Then he boots out stocks when their buybacks begin to wane, and replaces them with new pups. This active management may be one reason the strategy has outperformed the original Dow dogs approach.

One key to Fried's success is turning away mixed breeds, as lovable as they may appear. Fried rejects companies that look like they have big buyback plans in place but really don't, either because they fail to follow through or because they issue tons of employee stock options that dilute the shareholder base. To check on progress, Fried monitors share counts provided in quarterly reports.

A Different Breed

The buyback dogs strategy puts investors in an entirely different set of stocks than the classic Dow dogs approach. For example, in this market pullback a company like **Verizon** (VZ) would top the classic list of Dow dogs because it appears cheap since it has just about the highest dividend yield in the pound, or 4.5%.

Instead, Fried's strategy can land you in names that actually have the highest valuations in the Dow index. For example, **Microsoft** (MSFT) and **Procter & Gamble** (PG) have the second and fourth highest price earnings ratios for Dow stocks -- at 23.4 and 22. Both are well above the average P/E for the Dow, or 17.2.

Yet these two rank No. 2 and No. 3 in Fried's Buyback Dogs portfolio, because of the boatloads of stock they are buying back. Microsoft reduced its share count by 5.2% in the 12 months leading up to the end of the most recently reported quarter. Procter & Gamble cut its share base by and 4.1%. In contrast, Verizon reduced its share count by a measly 0.2%.

Even though the two Dow dog strategies are so different, they really do have something in common. In the sense that share buybacks are a kind of dividend for investors, Fried is still going for the companies that offer the biggest "dividend yield."

The Current Buyback Dogs Portfolio

Here's a quick look at five dogs that hunt, the lineup in Fried's current Buyback Dogs portfolio:

1. **Exxon Mobil** (XOM) : This energy giant tops Fried's Buyback Dog list because it returns so much of its vast oil wealth to shareholders. As of the most recently reported quarter, Exxon had shrunk its share count by 6.8% in the trailing 12 months -- the most among Dow companies. It just shows what a company can do when it's making $39.1 billion a year, Exxon Mobil's reported profits for 2006. Exxon also happens to be among the cheapest Dow stock by one measure, its price-to-sales ratio of just 1.08.

The largest company in the oil and gas industry, Exxon Mobil continues to use economies of scale to its benefit. "To achieve its lofty profitability targets, the company relies on its size and ability to integrate operations to squeeze efficiencies from its businesses," says Justin Perucki, who covers Exxon Mobil for **Morningstar**. To offset declining production in mature areas, ExxonMobil is plowing cash into big projects in the Middle East, West Africa and Russia.

2. **Microsoft**: Microsoft looks like the priciest Dow stock by one measure, its price-to-sales ratio of 6.11. But it's still the second-most desirable Dow stock, according to Fried, because it shrank its share base by 5.2% in the past 12 months, as of the most recently reported quarter. Recent 20% revenue growth (if you include deferred revenue) was fueled by hot sales of the Xbox 360 and continued strong performance in the server and tools business. The company is also at the start of a new product cycle, with the Windows Vista and Office 2007 upgrade.

3. **Procter & Gamble**: This consumer-products giant comes in third, thanks to a buyback that reduced its share count by 4.1% in the trailing 12 months. Procter & Gamble is a brand-name juggernaut with global sales of more than $70 billion and dozens of popular brands such as Gillette, Tide, Olay and Duracell. And it knows how to keep those brands alive through savvy use of consumer research.

4. **Home Depot** (HD) : Sales the world's largest home-improvement retailer have been hit by a slowdown in the housing sector that may not let up for awhile. But that's probably already priced into the stock. In the meantime, under new leadership the company is focusing on the basics, such as improving customer service and product availability. The company also has high hopes for its "Home Depot Pro" service -- or in-store sales of supplies to professional contractors.

Home Depot is also adding multilevel stores in urban areas and expanding in Mexico and Canada, and soon in China. In the most recent 12-month period it reported, Home Depot shrank its share count by 3.9%.

5. **International Business Machines** (IBM) This tech giant rounds out the Buyback Dogs portfolio because it recently shrank its share count by 3.9% as well. The company should continue to benefit from growth in information technology outsourcing.

Keep in mind that as good as the buyback dogs are over time, they're not guaranteed to hunt well every year. Last year, for example, the classic Dow dogs approach returned 30.3% while Fried's Buyback Dogs approach returned 25.29%. That just goes to show that even with Dow dogs strategies, every dog has its day.

At the time of publication, Brush had no positions in any of the stocks mentioned in this column, although positions may change at any time.

Brush is an award-winning New York-based financial writer. In addition to writing for RealMoney, he has a weekly market column on MSN Money called Company Focus, and a column called Insiders Corner at InvestorIdeas.com. Brush has covered business and investing for The New York Times, Money magazine and the Economist Group. He studied at Columbia Business School in the Knight-Bagehot Fellowship program and the Johns Hopkins School of Advanced International Studies. He is the author of Lessons From the Front Line, a book that offers insights on investing and the markets based on the experiences of professional money managers.

Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Brush appreciates your feedback; click here to send him an email.