

Stock Market Indices

A Perspective on The DJIA and S&P 500

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This article is designed to help you understand market indices and ultimately maintain your long-term investment focus. By understanding the Dow Jones Industrial Average (DJIA) and the S&P 500 indices, you will gain better insight into the mechanics of these indices as well as a few of their shortcomings.

We hear every day from the media how “the market” is reacting to geopolitical events, inflation, business and world news events. Essentially, the market indices rule the headlines, play on the emotions of the investor and influence their behavior. When the media reports on “the market”, they are actually referring to a set of indices. By gaining a clear understanding of how indices are constructed, you will be on your way to making sense of their daily movement, why not to invest in indices directly, and why they are not a suitable performance benchmark for the various asset classes in your stock portfolio.

Market indices are imperfect in their representation of the market; further, in some instances, relying too heavily upon them may produce greater risk, because the focus of asset classes in various indices is too narrow and will miss other asset class movements.

The DJIA “The Dow”

Doe Jones and Company was founded in 1882 by Charles Dow, Edward Jones and Charles Bergstresser (we can only assume it is never good to be last, or we might be checking the Bergstresser index). In 1896, Charles Dow had the idea to create a The Dow Jones Industrial Average benchmark that would reflect market conditions to help investors understand market changes. The DJIA includes 30 large cap companies (25% of U.S. equity market) which are subjectively picked by the editors of the *Wall Street Journal* (which is published by Dow Jones & Company). So, one of the most recognized and quoted

indices is based on an editorial board’s stock list, similar to the way we pick the best college football teams in country. To calculate the Dow, the current prices of the 30 stocks are added and divided by the Dow divisor, which is continuously modified due to stock splits.

Translating a Stock’s Movement into the Dollar Value

The WSJ editors utilize a price-weighted methodology to calculate the DJIA index. To understand how a change in any particular stock affects the amount the index changes, up or down, the stock’s price change is divided by the current divisor. For example, if General Electric was up \$5, divide 5 by 0.12493117 (as of 12-16-05), which equals 40.02. Thus, if the DJIA was up 100 points on the day, GE was responsible for 40.02 points of the movement upward.

In addition to a constantly modifying divisor, another downside to a price-weighted calculation is that it does not reflect the fact that a one dollar change for a \$10 stock is much more significant (percentage wise) than a one dollar change for a \$100 stock. Because of price-weighting’s associated problems, almost all other major indices, such as the S&P 500, are market-capitalization weighted. That being said, despite all its shortcomings, the DJIA is still one of the most watched indicators of stock market performance.

The S&P 500

The Standard and Poor’s 500 (S&P 500) is a *more* representative benchmark than the DJIA for tracking the market movements. The S&P 500 index committee, which is composed of analysts and economists, have compiled and tracked an index of 500 large companies based on market capitalization, profitability and liquidity since 1957. It is market-weighted and, since it includes 500 companies, it is a better indicator of “the market” than the DJIA, but also has some significant shortcomings.

Historically, the S&P 500 strategy for choosing stock inclusion has worked well, but, as you can imagine, the index’s performance became distorted during the years of the “Internet

Bubble”, i.e., at a time when one asset class or sector greatly out-performed all other asset classes. In this example, some tech companies grew in size, such as Qualcomm and Global Crossing, gaining entry to the S&P 500. This caused the index to become over-weighted in high tech, and it no longer reflected a balance of the overall market.

Making Sense of the Difference Between Asset Class and Index Movements

As noted earlier, both the DJIA and S&P 500 indices are imperfect benchmarking tools, not only due to their construction, but because of the limited universe of stocks they include. An *asset class* is a group of stocks identified by characteristics such as market capitalization or valuation factor, such as small cap or real estate. An asset class is not a small universe of “selected” stocks expected to replicate “the market”, and its performance and movement trends will not be completely in sync with indices such as the DJIA or the S&P 500. Therefore, most investors are surprised when they do not find similar correlations between their portfolio of asset classes and the newsworthy indices.

Because of this variance between the stocks held in an index versus those in an asset class, the performance between them will appear when large cap growth is out-performing other asset classes. The indices are heavily weighted with large cap stocks, so their performance will look much stronger than portfolios that include other asset classes holding stocks, such as real estate, small or mid-cap. Additionally, the DJIA and S&P

500 do not include foreign stocks, which, in total, represent a market larger than the U.S. Therefore, the best measure of the market is a collection of all asset classes that own worldwide equities and are not limited by the artifice of the DJIA and the S&P 500 qualifying criteria.

Unfortunately, some investors have made decisions based on the short-term performance (ok, short term can mean years) of the indices and doing so has significantly reduced their ability to capture the returns of asset classes that have a higher probability of having a higher expected return.

We at Genworth Financial utilize DFA asset class funds and slice the market into asset classes to capture the small cap and “value” effects that are not captured in either the DJIA or the S&P 500. The indices are useful tools if you know what they represent and what they do not represent. The indices capture one view of the market, while we attempt to capture a broader view, in order to reduce fluctuation in values (volatility) and capture the efficient return of the market. Indices provide a historical perspective, but they should not be viewed as “the market”.

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