Weekly Market Flash

The World's Most Loved, Least Useful Stock Index

June 22, 2018

Did you hear the news this week? General Electric, one of the world's oldest going concerns, was dropped from its august perch in the Dow Jones Industrial Average. That index of 30 companies will no longer include the only company still in business today that was a constituent member of the Dow Twelve – the companies Charles Dow fashioned into a market index back in 1896. GE will be replaced by Walgreens, which is probably not a bad idea since retail pharmacy is currently under-represented in the index (Wal-Mart being the only company in the heretofore 30 where you can get a prescription filled).

As with just about anything Dow-related, though, the news about GE and Walgreens matters more for stock market historians and storytellers than it does for actual investors.

A Quaint Relic

To the mind of the typical retail investor, "the Dow" is interchangeable with "the market." Round number days on this index – when it, say, breaks 20,000 for the first time – are feted like national holidays in the financial media. When the stock market experienced a technical correction earlier this year, commentators were breathless with the report that the Dow had fallen by more points (1,179 to be exact) than ever before in its history.

None of which matters for any reason other than idle water cooler gossip. In fact, the media's fixation on the Dow's points loss on February 5 was not only pointless, but potentially harmful if it induced anyone to actually sell out in a panic. The percentage loss corresponding to that decline of 1,179 points was nowhere close to the all-time record loss of 22 percent, on October 19 1987.

Yes, it's fun to study the Dow to gain a perspective on how the US economy has evolved over the last 122 years. It's nice to arrive at cocktail parties armed with trivia like Distilling & Cattle Feeding or Standard Rope & Twine (two of the original twelve companies that didn't have quite the staying power of GE). But that's where the usefulness ends. Consider the fact that of today's market-moving FAANG companies (Facebook, Amazon, Apple, Netflix and Google) only one – Apple – is represented in the Dow. Technology stocks make up about 25 percent of the total market capitalization of the S&P 500 (and an even greater percentage of the NASDAQ Composite). The tech names represented on the Dow – Apple, IBM, Cisco Systems, Microsoft and Visa – are not exactly unimportant, but they are less representative of the full spectrum of what is arguably the most influential sector of the US economy in 2018.

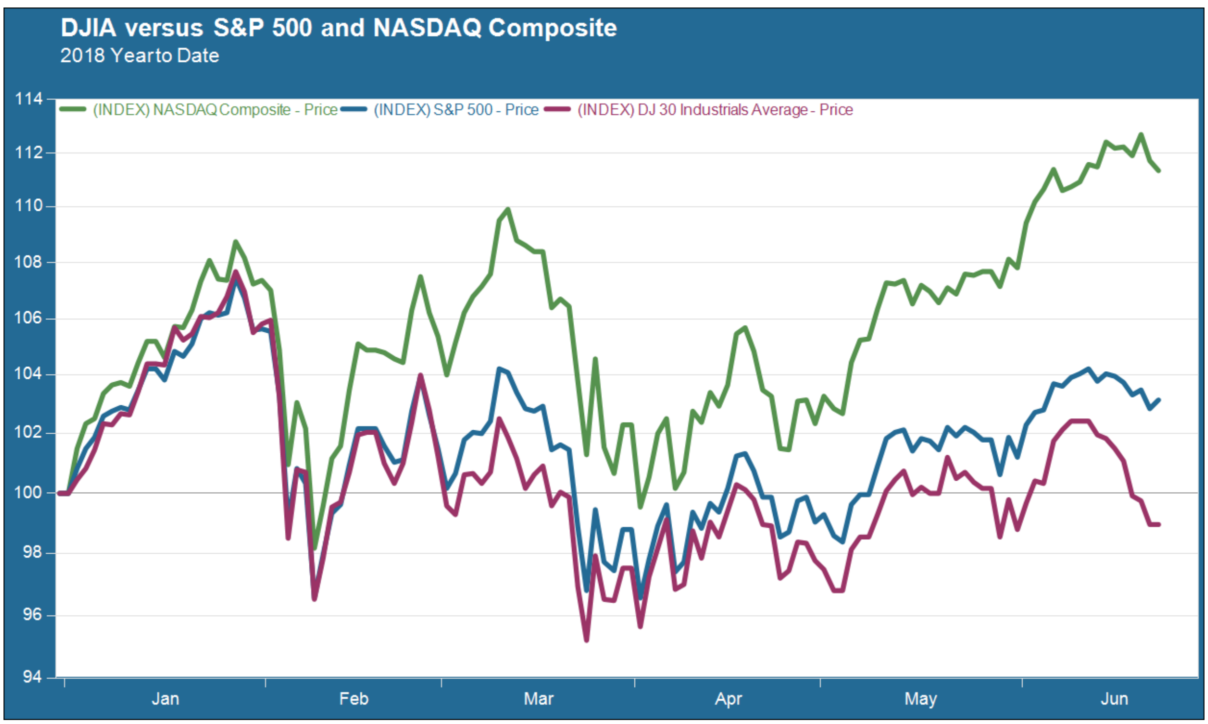
Price of Everything, Value of Nothing

The other major problem with the Dow, in addition to the somewhat arbitrary and backward-looking nature of the 30 constituent names, is the way the index's performance is calculated. Whereas the S&P 500, NASDAQ and most other broad market indexes calculate performance based on market capitalization (number of shares outstanding times share price), the Dow is a price-based index. This means adding up all the share prices of the 30 stocks and dividing them by a divisor (which changes over time to reflect share splits, share dividends and the like).

The basic flaw in the price methodology is that it gives stocks with a higher price more impact on returns than stocks with a lower price. If Company A has a stock price of $100 and Company B has a stock price of $10, then Company A's share price movements have a bigger impact on the index than those of Company B. But those raw share prices tell you absolutely nothing about the economics of either company. If Company A has 1,000 shares of stock outstanding and Company B has 10,000 shares of stock outstanding then both companies have the same market capitalization -- $100,000. In a market cap-weighted index like the S&P 500 their share price movements would have the same impact, not the skewed outcomes they produce on a price index like the Dow.

Here Today, Here Tomorrow

Of course, we do realize that all our carping about the Dow Jones Industrial Average will not stop it from being "the market" in the popular lexicon. Humans gonna be humans, after all. And that's fine, as long as you make sure that your actual portfolio pays more attention to today's economy than to the colorful past chapters of US stock market history. Now, there are times, of course, when the Dow will outperform the broader benchmarks, and there are times when it will underperform. As the chart below shows, right now is one of those times when it is underperforming – actually in negative territory for the year to date while both the S&P 500 and the NASDAQ Composite are in the black.



Source: MVF Research, FactSet

It's a nice bit of history, but there's no reason to have it in your portfolio. Exposure to large cap US stocks is best achieved through a broad market cap index like the S&P 500 or the Russell 1000. Adding other distinct asset classes like small caps, developed and emerging international equities can help achieve long term risk-adjusted return goals. That's prudent diversification, to which the Dow is just a frivolous sideshow. A fun sideshow (hello, Nash Motors, inductee of 1932!), but a sideshow all the same.

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