WHAT'S YOUR INDEX?

BY ERIK FORD

When following the financial markets in the news, the headline reports rely on the performance of certain indices. We may benchmark our portfolio performance against an index as well. Do we have a good understanding of these indices and how they may or may not be a good comparison for our own investment performance? For example, the two most cited US stock market indices are constructed very differently and that may not be understood by those that follow them.

Perhaps the most frequently referenced stock market index is the Dow Jones Industrial Average (DJIA). The DJIA tracks 30 publicly owned "blue chip" companies that trade on the New York Stock Exchange and Nasdaq. It was started in 1896 as an index of twelve stocks, expanding to 30 companies in 1928. Component companies are periodically replaced in order to maintain the index as a representative of the US economy, to the extent that 30 companies can represent the US economy. The current component with the longest tenure is Proctor & Gamble (since 1932) and the most recent adds were done in 2020 (Angen, Honeywell, Salesforce). Besides the arguably arbitrary selection of 30 companies to represent the US economy and equity markets, the calculation of the index is what is called "price weighted". This means that the weighting of each component is based on the share price of its stock. As a result, a given percentage move in a higher priced stock will move the index more than the same percentage move in a lower priced stock. Keep in mind that share prices have no relation to company size or relative importance in the economy. The index itself is calculated as the sum of the component stock prices divided by a "Dow Divisor", which is adjusted every time there are changes to index members, share splits or reverse splits in order to maintain consistency over time. It is not as straightforward as it may seem on the surface.

The narrow scope and share price-based calculation of the DJIA contrasts to the breadth and size dependent nature of the Standard and Poor's 500 (S&P 500). Comprised of 500 of the largest publicly traded companies in the US, the influence of any single stock on the index is based on its market capitalization, so larger companies have a greater influence on the index than smaller ones. The 500 stocks are still selected by a committee, but there is definitive published criteria for inclusion or exclusion from the S&P 500. By being weighted by market capitalization (number of public shares x share price), the S&P 500 is more influenced by the largest companies. For example, the largest ten companies represented in the index account for about 27% of the S&P 500, meaning that 490 make up the remaining 73%. The largest two account for over 12% of the index. So, while much more broad-based in total, the S&P 500 is concentrated, which is important to keep in mind when we observe changes and as we use it as a benchmark for our own portfolios.

So, what about bonds? The primary index for the US bond market is the Bloomberg US Aggregate Bond Index (Agg). The index was previously known as the Barclays Agg. It is also a market capitalization weighted index comprised of US investment grade bonds, subject to a minimum outstanding par value. The Agg currently tracks about 10,000 securities. As a result of the size of the outstanding US treasuries, treasuries represent nearly 40% of the index. This index is very broad, tracking the entirety of the investment grade universe. However, it still may not be an appropriate benchmark for a specific bond investment.

There are other indices for referencing other markets. These are overwhelmingly also capitalization weighted. For example, the Russell 3000 is an index that represents the entire US equity market. The index sponsor subdivides this total market index into the Russell 1000 for large capitalization companies, the Russell 2500 for small and mid-cap companies and the Russell 2000 for smaller companies.

For non-US equity markets, another market cap-based index includes nearly 900 stocks from 21 countries. The MSCI EAFE includes mid and large capitalization companies from Europe, Asia and the Middle East plus / Australia and Canada. While not the only international index, it is one that is most frequently referenced.

The Nasdaq 100 is another frequently cited large-cap index that tracks a basket of 100 large company stocks that trade on the Nasdaq Exchange, excluding financial services. It brings in companies from 27 different countries and is heavily weighted (56%) toward technology. For this latter point, it is frequently cited as a benchmark for the technology sector. It is also much more concentrated than even the S&P 500 as the largest five components make up 40% of the index.

The above are a few of the most frequently referenced indices for the US and international stock and bond markets. There are also many more covering different geographic areas, industries, company size, or a combination of factors. When determining what you may want to use to compare your investment results, it is best to choose the most appropriate benchmark, or combination of benchmark indices, in order to give yourself the accurate read on how you are doing and guide you in making changes or adjustments.

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