LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

Anyone who watches the news is used to hearing the commentators announce the results of the stock market for the day. Their normal procedure is to report the point change in the Dow Jones Industrial Average (DJIA) and the Standard & Poor's 500 (S&P500). But how many of us really know what each of these stock market indicators are comprised of, how they are calculated, and whether or not they really mean much?

The DJIA is the best-known measure of the stock market. It really isn't even an index, but as the name implies, it is an average—a price-weighted average—comprised of 30 stocks which are generally considered to be the leaders in their industry and are selected by a committee from Dow Jones. The DJIA is computed by adding the closing prices of those 30 stocks and dividing by 30 to obtain the average, then applying a *divisor*—to account for the numerous splits and additions/deletions since the average's inception in 1928. The resulting number is the level of the average you hear about every day.

The S&P 500 is a capitalization-weighted index of 500 stocks and is considered by many to be the best single gauge of the large-cap U.S. equities market. All companies in the S&P 500 are selected by a committee. It includes the leading companies in the leading industries of the U.S. economy and captures approximately 75% of the total U.S. market capitalization. Each company in the S&P 500 must have a market capitalization (price times the number of outstanding shares) of at least $4.0 billion and must be U.S. domiciled. They must also be operating companies. Preferred stocks, closed-end funds, ETFs, ADRs, ADSs, partnerships, and royalty trusts are not eligible. The S&P 500 Index is computed by adding all the market capitalizations of the constituent companies and dividing the resulting number by a *divisor*–that adjusts for all of the additions/deletions, share issuances/repurchases, and spinoffs/mergers since the index base period of 1941-43.

Being a price-weighted average, the daily movement of the DJIA is influenced greatly by the highest-priced stocks in the index even when their market capitalizations are less than some of their lower-priced peers. The DJIA excludes a few very large companies—including Apple and Wells Fargo—but conversely, it also excludes hundreds of smaller companies.

Since the S&P 500 is a market value-weighted index, changes in price of companies with higher market capitalization have a proportionally larger impact on the index. On June 30, 2012, Apple Inc. was the largest company in the index with a weight of 4.45%. At the other end of the spectrum, Washington Post had a June 30th weight of 0.01%. The largest 10 holdings make up more than 20% of the index so obviously, the largest stocks drive the index.

Despite the differences in the DJIA and the S&P 500, the 30 Dow stocks make up more than 30% of the value of the S&P, which would suggest that there should be a fairly high level of correlation between the two benchmarks over longer periods of time. On an annual basis it is rare for the returns to differ by more than 5 or 6 percentage points, and there doesn't seem to be a greater likelihood for one to outperform or underperform the other. The lesson here is to not get too hung up on short-term movements. Over ten-year periods, the returns between the two are remarkably similar.

The main point to remember is that an index is only a number—not an individual portfolio. An index is simply a group of companies selected by a committee based on certain criteria, none of which is valuation. Unlike an individual portfolio, an index has no goals and objectives and the companies and industry groups chosen for inclusion do not necessarily represent suitable choices for particular investors.

July 2012

450 Regency Parkway, Suite 410 | Omaha, Nebraska 68114-3701 | *tel* 402.392.2606 | *fax* 402.392.2597 | www.lawsonkroeker.com