The New York Stock Exchange at sunset, in lower Manhattan. The Dow Jones Industrial Average was first published in 1896. The original index included 12 stocks. The calculation method is simple and can be done by hand – since that's how it had to be done in 1896! The Dow has grown to 30 stocks and the companies making up the index are now chosen by the editorial board of the Wall Street Journal. **Mary Altaffer** AP

PERSONAL FINANCE

The Dow is a lousy index for today's stock market

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Did you hear that the Dow Jones Industrial Average (the Dow) recently crossed the 22,000 mark, and hit an all-time high of 22,118.86 on Sept. 12?

What the headlines don't tell you is this is an effectively meaningless benchmark for today's stock market. The number of companies included in the index (30) and the method of calculation (price-weighted) in my opinion make this index a poor measure of how the U.S. stock market is doing.

History

The Dow Jones Industrial Average was first published in 1896. The original index included 12 stocks. The calculation method is simple and can be done by hand – since that's how it had to be done in 1896! The Dow has grown to 30 stocks and the companies making up the index are now chosen by the editorial board of the Wall Street Journal.

The simple calculation method for the Dow has inherent flaws.

The methodology used is known as a “price-weighted” calculation. The weight of each stock in the index is determined by its price. The stocks with the highest prices have the largest weighting in the index and will therefore have the largest impact on the return of the index.

When calculating the Dow, one adds up the market price for each of the stocks in the index, and then divides by the number of stocks included in the index. This gives you a simple average of the stock prices for the companies in the Dow.

Corporate actions such as mergers can significantly impact the price of a stock, so to prevent giant swings in the index, the “Dow Divisor” was introduced. The divisor in the calculation of the index is adjusted periodically when corporate actions occur, or when companies are added or subtracted from the index. This helps keep consistency with the index.

Methodology madness

The primary criticism of the Dow’s calculation methodology is that the stocks that make up the largest portion of the index are driven by the company’s stock price and not by the size of the company or some other measure of the company’s impact on the U.S. economy.

For example, the two companies with the largest weightings in the index are Boeing and Goldman Sachs. However in terms of size (as measured by market capitalization), out of the 30 companies in the index, Boeing ranks 21st and Goldman Sachs ranks 27th. In other words, two of the smaller companies in the index have the largest impact on the Dow’s movements because their stock price per share is higher. That doesn’t make any logical sense.

Another example illustrating the nonsensical nature of the Dow is the impact of Visa’s stock split in 2015. Visa had the highest stock price and therefore the largest weight in the index before it completed a 4-for-1 stock split in March of 2015. This stock split brought the share price down from about $267 per share to about $67 per share. Visa’s weighting and impact on the Dow went down substantially even though nothing else had changed with the company!

A better measure

Since we’ve established that the Dow is a poor gauge of how the U.S. stock market is performing, what’s a better option?

The S&P 500 Index is the much better candidate of the major indexes that are commonly quoted. This index is made up of the 500 largest publicly traded U.S.

companies and is weighted by the market capitalization of these companies. The large number and diverse mix of companies coupled with a logical weighting methodology make this the preferred major U.S. stock market index.

There are a several lesser known indexes that take an even larger sample of U.S. companies and include many small and mid-sized companies. Indexes such as the Wilshire 5000 and the Dow Jones Total Stock Market are arguably better gauges of the total U.S. market when compared to the S&P 500.

The next time you hear a news report touting a new record for the Dow, know that this is not really useful information. Instead, focus on a better measure like the S&P 500 to get meaningful insights into how the stock market is doing.

Lucas Bucl is a principal at KHC Wealth Management in Overland Park. He helps clients balance living well today while executing a financial plan to achieve their future goals and dreams.