The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 7 - Issue 10

Investing

What market indexes are – and how they work (Part 2)

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Last month we discussed what stock market indexes are, and the three different ways companies are weighted in them.

In Part 2 of our look at market indexes, let's examine the specifics of a few of the major indexes.

The Dow Jones Industrial Average is the most frequently cited index. Made up of 30 companies, the Dow, as it is called, is supposed to represent the overall U.S. market. The Dow uses the *price-weighted method* to weight its stocks. As you will remember, higher-priced stocks will have a greater influence on this type of index. However, while the 30 companies are all mature and established leaders, they may not be the best barometer for the overall U.S. stock market. By only having 30 companies, it excludes smaller and mid-size companies. Despite these drawbacks, the Dow is still the most storied and recognized index, having existed for over 120 years.

The S&P 500, meanwhile, tracks 500 companies to reflect the broad performance of the U.S. stock market. With the much bigger sample size, the S&P 500 should provide a more accurate representation of the U.S. stock market. However, despite holding so many stocks, this index can be influenced by larger companies due to its *market-cap-weighting method*. In fact, the largest 10 companies in the index make up almost 20% of the index. And the top three companies make up more than 7% of the index! Again, the concept of taking the profits of stocks that have gone up in price is absent in this type of weighting.

In Canada, the main index is the TSX. It's made up of about 240 companies. The TSX uses the same market-cap-weighting method as the S&P 500. But, with a smaller sample and fewer companies in Canada, the TSX is even more heavily influenced by larger companies. The largest 10 companies comprise over one-third of the index. The top three companies make up over 15% – and they are all bank stocks, so diversification is an issue.

In summary, there's no perfect index that works in all situations. Biases exist in the selection method. And the different weighting methods can skew performance. Yet despite these issues, the above indexes are the standard and are widely used. That's why it is important to understand both how they work and where they are best suited to work.

For our international strategies, we use *country indexes*. These give us a diversified, efficient and low-cost method of investing internationally. Diversification is extremely important, ensuring that the issues surrounding indexes are minimized. Our individual stock portfolios have limits on position sizes, industry and geography to make sure we are spread out to help minimize the risks. ■

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