

The Sound Investor Series #24

Stock Market Indexes – How They’ve Changed!

By Ed Hynes, CFA

November 16, 2005

Last week I discussed how various stock market indexes measure the performance of the market. We discussed how the Dow Jones Industrial Average (DJIA) came into being and that it is a “price weighted index.” The article went on to explain how the S&P 500 index works and since being a “capitalization weighted index” it more accurately measures the performance of investors in a market. (If you missed it check out my website.)

Let’s continue this discussion of stock indexes and see how a funny thing happened to them as they got older. Instead of only fulfilling their original role of measuring the market, indexes have morphed to have an additional role as investment vehicles which you can actually buy and sell.

This change is not necessarily good or bad, but it is important to recognize it and be on the lookout for problems.

This morphing got started in the mid-70s when John Bogle noticed that most mutual funds underperformed the S&P 500. He had a brilliant idea that investors should buy the whole market and forget about trying to beat it. After stock commissions were deregulated in 1975, he started the Vanguard S&P 500 mutual fund. It invested in most of the stocks in the index and became the first “index fund.”

When Mr. Bogle started his fund, the S&P 500 was probably the only index which made any sense to use. It covered most of the market and was a good benchmark.

S&P encouraged investors to use their indexes as benchmarks and also pushed for investors to invest in the S&P 500 by licensing the index to exchanges and mutual funds. Another watershed came in 1982 when S&P licensed the Chicago Mercantile Exchange to create the S&P 500 futures contract.

During the 1980s and 1990s the index field became more competitive. Companies like Frank Russell developed the Russell 1000, 2000 and 3000 family of indexes which are now widely known. The Russell 1000 tracks the largest companies while the Russell 2000 tracks the next 2000 largest companies. The Russell 3000 combines the 1000 and 2000.

While the S&P 500 continues to be the most popular for measuring large cap stocks, the Russell 2000 is a widely used index for tracking and investing in small caps stocks.

On the international side, a joint venture between Morgan Stanley and Capital International popularized the MSCI family of indexes. Now part of Morgan Stanley, its most famous index is EAFE which covers all the international developed markets. (EAFE stands for Europe, Australasia and the Far East.)

The past 10 years have seen an explosion of competing indexes. Many factors drove this growth including the surging popularity of Exchange-Traded Funds (ETFs).

If you want to purchase an ETF covering at least 90% of the U.S. market, you now have four index choices including:

- S&P 1500
- Russell 3000
- Dow Jones Wilshire 5000
- MSCI U.S. Broad Market Index

Consider which one will have the best performance and you will see how everything is now turned on its head. Rather than looking to an index to measure the market we now want to pick the index that will go up the most!

Popularity is not necessarily the best method for picking an index because they can be negatively affected by having too much money follow them. The biggest problems result from changes to the index. These announcements allow other traders to know exactly when all the indexers will shift from following one stock to another. While not all the money invested in the indexes will shift at that time, a large amount will.

If a lot of money is involved, traders may push up the price of stocks in anticipation of it being included in the index. The run up often ends with the stock falling in the days after the change. This price action creates a drag on the index's and the investor's performance as they are only exposed to the fall after the change. Many traders are now waiting to pounce on Google if and when S&P adds it to their family of indexes. It should be interesting to watch.

One big difference between S&P and the other indexes is how additions and deletions are made. S&P uses a committee to make decisions while the Russell, Dow Jones Wilshire and MSCI indexes are strictly rules based. Overall, I would suggest that rules based indexes are superior for measuring markets but committee based indexes are more practical for investors.

All these indexes are high quality, but if I had to choose one I would pick the S&P 1500.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at Farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.

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