

Financially Speaking

With Trisha Arndt

Individual Investments Don't Necessarily Follow an Index

I was recently meeting with a client to review his accounts and I found myself at a bit of a loss. We were talking about how much his investments have grown and how the investment markets have done in general. He kept asking why specific holdings had gained more or less than “the market”. My answers didn't seem to make sense to him so I finally asked him what he meant by “the market”. He looked at me a little strangely and replied, “The stock market, you know, the Dow.”

Ah. Now I get it.

With a degree in finance, my CFP designation and over twenty years of experience in the financial industry I guess I may have started to forget how people without my background might perceive what they see in the news. Taking a step back I can easily see how someone might assume that when a reporter says something like, “stocks were down marginally today” or a headline reads, “Stocks gain 1% as S&P 500 Index hits new high” that the stocks they own would have followed suit. Unfortunately, it's not that simple.

The stock market is actually comprised of dozens of stock exchanges, some with physical locations and some essentially electronic, all around the world. Literally thousands of individual stocks (you can find my article explaining what a stock is on my website if you'd like a refresher) are bought and sold on those exchanges every day. Investors buy shares of stocks that they think are attractive and sell those that they no longer want to own. Those decisions are made based on a variety of factors, some related to general things like the economy and others related to company specific expectations, like plans to build a new plant or expand into another country.

Because there are a multitude of reasons to buy or sell a given stock, their prices don't all move in tandem. To try and give investors a general idea of how stocks were doing Charles H. Dow, a finance journalist, developed the first stock index, called the Dow Jones Industrial Average (Dow), in 1896. It was a simple calculation that tracked the average price of the 12 biggest stocks in the US at the time. Since then the Dow has expanded slightly but still only follows the prices of 30 stocks.

Over the years many more stock indexes have been developed, focusing on either very limited types of stocks or trying to give a broader picture by following a range of them. Besides the Dow, the most commonly referenced index is the S&P 500 Index. While certainly more broad than the Dow, the S&P 500 Index only tracks large companies based in the United States. It doesn't include stocks of smaller companies, like Duluth

Holdings or Exact Sciences, and it doesn't include stocks of companies based outside of the United States like Sony and Nestle.

In addition to not following all types of stocks, the S&P 500 Index uses a market cap weighting calculation which means that the largest companies in the index have more of an impact on how it moves than the others. For example, Rob Isbitts at Marketwatch, wrote an excellent article in May of this year explaining how at that time 10% of the S&P 500 Index was comprised of just 3 stocks. To get to 20% of the index, he explained, you just had to add 7 more stocks. In fact, while there are several thousand stocks trading in the US, and thousands more across the globe, half of the performance of the S&P 500 Index can be attributed to just 50 stocks according to Isbitts.

Unfortunately what often happens is that people see a headline saying that the Dow or S&P 500 are up and don't understand why their international or small company stocks are not. And company size and location aren't the only things that differentiate them – sometimes certain sectors, like big technology stocks, can make an index go up even though more than half of the stocks in the stock market actually decline in value (2015 anyone?).

The important thing to remember is that indexes are intended to give the general sense of direction for the type of stocks that they track by using some type of method to calculate and follow an average. That doesn't mean that every individual stock within the index, or across the stock market as a whole, will move in the same way. And certainly you shouldn't expect all stock investments to have the exact same performance as any one index, no matter how broad.

Does that mean that stock indexes aren't useful or that you shouldn't pay attention to them? Of course not. Stock indexes were designed to give a general idea of how the average price of the stocks they follow are moving. There is certainly a value to that, it's just important to take information with a grain of salt and understand that the stocks you own may, or may not, even be part of a given stock index. Know what you own and don't get too caught up in how the prices move over the short term if you feel like they are good long term holdings.

All indices are unmanaged and investors cannot invest directly into an index. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties which are difficult to predict. Past performance is not indicative of future results. Diversification does not ensure against market risk.

Trisha Arndt, CFP[®], is President of Wealth Strategies of Wisconsin Ltd, 901 Kimball Lane, Suite 1400, Verona, WI 53593, 608-848-2400. Securities and Advisory Services offered through Commonwealth Financial Network, member FINRA/SIPC, a Registered Investment Adviser.