

Financially Speaking

With Trisha Arndt

The Ins and Outs of Market Indexes

To market to market... Having recently been blessed with the birth of my second son I've been finding myself reciting nursery rhymes in my head the way I once did the latest pop single. I was doing so recently during one of many nightly feedings when my mind drifted off to a conversation that I had recently had with a mortgage broker based here in town.

He was in the process of reviewing refinancing options for a client of his and wanted to ask me some questions about how to gauge investment market performance. His questions were similar to those that I have been broached with many times over the years.

In today's age of 24 hour news channels, internet search engines and blogs, there has never been more readily accessible information on what is going on in the investment markets.

But do we really understand the information we are receiving?

The market reports that we hear and see are generally referencing a handful of indices, defined as "statistical composites used to measure and report value changes in representative security groupings in relation to an earlier established base market value".

Whew, that's a mouthful.

Let me try to interpret. Basically an index tracks the value of a group of securities over time. The value of the index is expressed based on the increase in the value of that said group of securities from the index's origination or starting point. If the value of the underlying securities increases in a given day the index value, generally expressed in points, rises. If the value of the securities decrease, then so too does the index. All indices are unmanaged and are not available for direct investment by the public. Past performance is not indicative of future results.

Seems like a simple concept but in practice calculating index values is quite complex. Indexes use different methods of calculating their value, have different starting points and account for things like dividends and stock splits differently.

There are a multitude of indexes out there but the most commonly quoted include the Dow Jones Industrial Average (Dow), Standard & Poors 500 Index (S&P 500), the Europe, Australia and Far East Index (EAFE), the Lehman Brothers Bond Index (Lehman) and the National Association of Securities Dealers Automated Quotations System (Nasdaq). While each index tracks its own set of securities, there may be some overlap between them.

There are several common misconceptions that I run into about indices.

One of the biggest misconceptions that people have is that the movement of the Dow, the oldest and most widely quoted index, represents the movement of all securities. In fact, the Dow, like all indexes, represents the average movement of only the group of securities it follows, not all securities in the market and not each security in the index individually. It is very possible for an index like the Dow to be down for the day and a given individual holding to be up, or vice versa.

It is also very possible for the indexes to have different outcomes on the same day – the Dow can be up on a day when the Nasdaq is down for instance.

It is important to understand what the index being referenced tracks and what you own personally in order to know how your portfolio may have been affected by the day's activity.

It may surprise you to learn for instance that, despite often being quoted by the news media as “the market”, the Dow tracks only 30 stocks, most of which are large, blue chip industrials - hardly a broad overview of the securities markets. So if your portfolio consists of all small cap international stocks the movement of the Dow for a given period may not correspond at all with how your investments perform.

Because it follows stocks of companies of different sizes, traded on multiple exchanges and falling in several sectors, many professionals use the S&P 500 as a benchmark for overall domestic stocks. Similarly the EAFE is often used as a benchmark for international stocks and the Lehman as a benchmark for corporate bonds.

Keeping abreast of what is going on in the market place can be important for people in all stages of their financial lives, from accumulation to retirement. If you are uncertain, consider consulting your financial representative to determine which index or indices it would make sense for you to follow and remember that in most cases it is the long term results that matter, not what happens in a short time period.

If you have a question that you would like answered or a suggestion for a topic that you would like to see in a future issue please e-mail trisha@wealthstrategies.biz.

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