Financially Speaking

There are a lot of ways to measure stock market performance

Many years ago I had a meeting with a client who was very perplexed and didn't understand why his stock had gone up more than a certain percentage the prior year. I explained that the company had announced some things that investors really liked, helping the price to go up so much.

He still seemed confused and kept referencing the same percentage as what he clearly thought the stock was supposed to gain during that time period. I asked more questions and finally I realized what was causing the confusion. He had read a headline that said something like, "stocks gained X percentage for the year" and thought that was what the performance of EVERY stock was.

Looking back, I realize I should have figured out his question much quicker. Like most people, my client hadn't spent years learning about investments and didn't spend every day following and understanding how the investment markets work. For someone without my background I can totally understand how reading that headline would lead someone to believe what he did.

I thought of that conversation recently and decided it would be a good time to write something to help people understand what it means when they see a headline like the one my client saw.

There are thousands of companies whose stock trades publicly, meaning that you can buy and sell them on public exchanges, collectively known as the market. Every day that the stock market is open millions of shares of stock are bought and sold, with the price of each fluctuating independently. Virtually every trading day some stocks will go up in price and some stocks will go down. Stock prices do not all move in lockstep.

To help investors understand the general direction that stock prices are moving Charles Dow, the co-founder of the Wall Street Journal, worked with a statistician, Edward Jones, to calculate the first stock indexes back in the very late 1800's. One of those indexes, the Dow Jones Industrial Average, is still one of the most commonly referenced stock indexes to this day.

Today there are tons of stock indexes that attempt to calculate the general direction of stock prices. Many of them follow only a certain type of stock or a certain industry, such as small or technology companies. Other indexes are broader and attempt to provide a more diversified snapshot of the direction of stock prices.

While stock indexes can be a very helpful and informative tool, they can also be misleading and cause confusion if you don't understand the stocks they include and how they are calculated.

A really good example of this potential for confusion comes from what is probably the most commonly cited US stock index, the S&P 500 Index. The S&P 500 Index is often used as a quick reference point for how the US stock market is doing, and is, in fact, the index that the headline my client read years ago was talking about.

The S&P 500 Index actually follows 503 stocks of mostly larger US companies. It is what is called a cap-weighted index, meaning that the calculation that it does for performance weights the gains/losses of companies based on that companies' total size, i.e. what it would cost to buy every share of stock of that company. The rationale is that the index should attempt to track the total gain/loss in investor value for the time period so if there is more money in a given company then it should count more.

That rationale is logical but is it the best index for individual, diversified investors to compare their performance to?

In 2023 we have seen a handful of very large, primarily technology companies grow even larger as excitement about artificial intelligence has grown. Investors have been eager to buy companies in that area, even though concerns about the broader economy remain. As a result, the "magnificent seven" as they are being called, have seen their prices jump while the stocks of many other companies have not done as well.

Those seven stocks are all part of the S&P 500 Index and, as of today, their stocks make up 27.5% of the total index. That means that over a quarter of the performance of the index is driven by just how those 7 stocks have done.

As a comparison, the S&P 500 Equal Weight Index tracks the same 503 stocks but calculates the performance by averaging how all of the stocks have done equally. Some believe that this is a better calculation for investors that are diversified because it doesn't give a higher weight to any one company or industry.

In some time periods this difference in methodology can result in a significant difference in performance. For example, through June 30th of this year the cap-weighted S&P 500 Index gained 15.91%. For the same time period, the S&P 500 Equal Weight Index was up 5.97%. Both of these indexes calculate performance by tracking the same group of stocks but clearly they tell different stories.

In the end, investors need to know what they own and select an index, or indexes, that make sense to watch for their own portfolio. There are many ways to measure stock market performance and they are not all created equal.

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. All indices are unmanaged, and investors cannot invest directly into an index. Diversification does not ensure against market risk.

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