Mitch on the Markets

Why You Should Forget About the Dow Reaching 20,000

By Mitch Zacks
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There is a growing fascination with the Dow Jones Industrial Average (DJIA) reaching 20,000. The index has never reached that level, and there's an ongoing narrative that reaching and eclipsing that number is a big deal. The emergence of this narrative isn't surprising – humans have an affable obsession with landmarks and anniversaries, so of course the Dow reaching 20,000 is a huge event.

I hate to be a party spoiler, but the Dow reaching 20,000 doesn't really mean anything at all. For two reasons: 1) stocks generally aren't affected by landmark levels or "all-time highs," and 2) the Dow is a faulty index. This article will focus on point #2.

The Dow Jones Industrial Average is a Flawed Index

The "Dow" has been around since 1896, when Charles Dow first calculated the average of 10 Industrial stocks (General Electric was one of those 10 stocks, and it is still in the DJIA today). There's a lot of history and nostalgia to the Dow average, and for that reason it will probably always be a barometer for measuring the health of the stock market. But this doesn't mean it should be.

The Dow's most fatal flaw is that it is a *price-weighted index*. That means that the higher a company's stock price, the more influence it has over the movement of the DJIA. Here's how it works in a nutshell: a stock listed in the DJIA has its price converted into points, so as its price changes so do the amount of points it contributes to the DJIA. In order to calculate how many points a stock contributes to the average, you divide its price by 0.14602128057775 (as of March 2016). The higher the stock price, the more points it contributes to the Dow.

Read that last sentence again: *the higher the stock price, the more points it contributes to the Dow.* With that logic, a company with a share price of $100 is twice as important to the index's average as a company with a $50 share price. To help you understand why that doesn't make sense, consider these two current members of the Dow:

Travelers Co. (ticker TRV): $120/share
General Electric (ticker GE): $31.69/share

Travelers Co. is an insurance company with a market capitalization of $34.38 billion – a fairly big company. But its price movements influence the DJIA *four times as much* as General Electric, which has a market capitalization of *$279.37 billion*! So, GE is a company eight times the size of Travelers that also has one-fourth the impact on the DJIA's daily changes. It doesn't make logical sense.

The methodology behind the Dow also breaks down any time a company issues a two for one stock split or any kind of change to price and share count. A company that undergoes a 2-for-1 stock split now has half of the influence over the Dow as it did before the split, even though its market capitalization didn't change at all. With only 30 stocks in the index and given it is price-weighted, the Dow simply doesn't do a good job of providing a broad picture of how the U.S. stock market is performing.

Bottom Line for Investors

Focus on fundamentals and follow the S&P 500. The Dow reaching 20,000 shouldn't cause investors to think, "what happens now?" It's just another day and another arbitrary number. Stocks are in a constant pattern of reaching new, all-time highs – that's the nature of bull markets. So whether the Dow reaches 20,000 or 25,000 shouldn't matter. It's about what the fundamentals of the economy and corporate finance are telling us, and right now both are trending solidly, in our view.

The S&P 500 is a capitalization-weighted index, and it includes approximately 500 companies – a much better barometer of the broad market. So forget about the Dow at 20,000 or any other level – focus on the S&P 500 and don't let landmarks dictate how you invest.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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