

How Now Dow?

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Market Insights

Why the Dow Jones Industrial Average is Losing its Relevance?

Okay. I have been rather measured in my blog commentary for some time. My approach has been to try to help investors understand current events in the financial markets and to help decipher unusual or opaque market patterns. But sometimes things happen that make you want to scream!

S&P Dow Jones Indices announced yesterday that the composition of the Dow Jones Industrial Average will change next Monday. The “guardians” of the index will be replacing Exxon Mobil Corp., Pfizer Inc. and Raytheon Technologies Corp. with

Salesforce.com Inc., Amgen Inc. and Honeywell International Inc. Why are they making these changes now and how do these changes make the Dow 30 index more relevant?

The press release from S&P Dow Jones Indices says: "The index changes were prompted by DJIA constituent Apple Inc.'s decision to split its stock 4:1, which will reduce the index's weight in the Global Industry Classification Standard (GICS) Information Technology sector. The announced changes help offset that reduction."

So, let us understand how the index will change. The Dow Jones Industrial Index is what is known as a “price-weighted” index. That means that the overall size of the 30 companies (either in terms of market capitalization, revenues, profits) does not matter whatsoever. The only aspect that matters is price per share. For example,



United Healthcare (which will now have the highest weighting in the index by virtue of its \$300+ share price) is about 20% larger in market capitalization than Verizon Inc. But United Healthcare's weighting in the index is 5 times larger because of the price per share being 5 times larger.

Perhaps even more troubling is the new weighting of Apple in the Index. Apple is the largest company in the world on the basis of its market capitalization, which recently surpassed \$2 trillion. After the stock split, which does not in any way affect the company's importance or financial condition, Apple will see its weighting in the index reduced substantially. United Healthcare, which has a market capitalization of about 1/6 of Apple's, will have a weighting in the index more than 2 times higher. Absurd, wouldn't you say?

The Dow 30 average was at one time a good benchmark for how the largest companies in the US were performing. One of its shortcomings has always been that it did not reflect the broader stock market performance. But recent changes in the index clearly demonstrates a growing shortcoming. The index has become a progressively poorer indicator of how even the largest companies in the US are performing. It is time for Dow Jones to change their index methodology. Otherwise, the venerable Dow 30 will end up in the ash heap of history before long.

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