Dowdy Dow Jones out of touch with the market realities

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Body

The Dow Jones Industrial Average is a relic. It is also having its worst period of underperformance against the S&P 500 since the dotcom bubble, and before that, the soaring inflation and interest rates of the late 1970s and early 1980s. The Dow's terrible performance could be a sign that we're at another turning point for the -markets.

In one sense, it definitely is a turning point. The Dow is a measure of companies that used to be considered great, while the S&P is dominated by companies that are currently considered great. In times of change, the two move apart, as the S&P rebalances toward the newest companies, and the Dow doesn't.

That is exactly what has happened. The chip maker Nvidia is the most obvious example, riding the artificial intelligence boom to become the third-largest company in the S&P, with its shares leaping more than 200 per cent in 12 months. The Dow missed out, with chip-making represented by the former icon Intel. Its shares are slightly down over 12 months. The Dow is lagging behind the S&P by 5 percentage points this year, which is bad enough, but looks truly dire since the pandemic. Over the past 41/2 years, it is up 41 per cent, while the S&P has risen 68 per cent; the gap reached 30 percentage points last month. The Dow has remained that far behind over such a period only twice since the Great Depression, in 1976-80 and during the 1999-2000 dotcom bubble.

We can look at this underperformance in two ways, clinically and cynically. Regular readers won't be surprised that I lean cynical, but I'll start with the clinical.

Clinically, the Dow is a badly designed index that gives outsize weight to certain stocks based on the share price, rather than the market value used by almost all other large indexes. That frequently leads to bizarre outcomes.

Currently, the biggest weights in the 30-company Dow are given to UnitedHealth, which is the 15th-largest listed company, and Goldman Sachs, the 63rd biggest. Together they are valued at about half a trillion dollars, but they move the Dow more than their fellow constituents Microsoft, Apple and Amazon combined, even though the three are valued at more than $US7.5 trillion combined. The Dow is simply a bad measure, and ought to be retired.

Look at it cynically, and it captures something about the way the market changes, because it is so anchored in the past and often tries to catch up at just the wrong moment.

In the dotcom era, the Dow was "old economy" while the S&P captured the "new" economy of internet stocks. Just as with Nvidia today, companies overlooked by the Dow soared to stunning gains, while the dinosaurs that were made members decades before missed out. For Nvidia today, think ***Cisco*** Systems in 2000. It also gained more than 200 per cent over 12 months, was also the country's third-biggest company by value, and was also not in the Dow.

Of course, the old economy is the right place to be when the new turns out to be a mirage - ***Cisco*** shares went on to lose 89 per cent of their value.

In terms of timing, the smart move has been to sell stocks selected by the Dow committee at times of great change. The new stock or sector has typically been added to the Dow late, and has often been a sign that excitement about it was close to a peak.

In late 1999, the Dow rebalance added Microsoft and Intel to reflect the increased importance of the technology sector. After a brief spurt, the dotcom bust left both below the price at which they entered the index for another 15 years - and Intel is again lower now than when it joined the Dow, almost 25 years on.

The same happened in the 1979 rebalance, when IBM returned to the index in order to represent the increasingly important tech sector. Its shares promptly plunged, and took 15 years to sustainably pass the price at which it entered the index. The carmaker Chrysler and the food company Esmark, which left when IBM joined, far outperformed it.

The truly cynical would say this is just another example of the uncanny ability of journalists to sell at the bottom and buy at the top (the Dow is now owned by S&P Dow Jones Indices, but two Wall Street Journal editors sit on the index committee).

The trouble is that trying to choose just 30 stocks to represent the economy makes the selection committee resist putting in new members until they have been doing so well for so long that doing so can't be avoided. At turning points in the economy, this is risky because that is when the new players are often highly overvalued.

To be fair, the Dow committee often gets it right. Even as a dotcom-era investment, Microsoft did eventually come good. Over time, the Dow has performed surprisingly like the S&P given it has only 30 stocks (though not similarly enough to justify the attention given to it).

But right now it feels as though the Dow has missed another turn in the markets and economy. Interest rates have shifted permanently higher from their super-low levels of the 2010s, and the 40-year bond rally that began in the early 1980s is over. Big tech dominates the stockmarket.

Investors watching for a market turning point might worry that Amazon's being admitted earlier this year - after it almost doubled in 12 months - is a sell signal on the scale of Microsoft's or IBM's entry.

For the rest of us, the Dow's history offers a reminder that a small portfolio can easily miss major shifts in the market. THE WALL STREET JOURNAL

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