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Understanding Indexes

Indexes

What is an index?

An index is a group of securities reflecting a securities market or a particular segment of a securities market. It is used to measure and report the fluctuations of the market or market corner it represents. As you might guess, stock indexes track the stock market, and bond indexes track the bond market. Largely because of the popularity of stocks over bonds as a vehicle for the average investor, stock indexes far outnumber bond indexes. There also are indexes for various other markets, such as commodities and currency.

Both types of indexes can help you with the process of building and running your investment portfolio. You can structure part of your portfolio to replicate a particular index, you can invest in mutual funds or exchange-traded funds that are based on a particular index, or you can simply use indexes to monitor various markets. The headings that follow provide more detailed information on various indexes, including descriptions of specific indexes you might consider using.

Stock indexes

A stock index is a standardized composite used to measure and report value changes in representative stock groupings (i.e., a theoretical portfolio). Strictly speaking, a stock index is distinct from a stock average. While a stock average is simply the arithmetic mean of a group of prices, a stock index is an average expressed in relation to an earlier established base market value (e.g., the S&P 500 uses 1941 to 1943 as a base period). In practice, however, the distinction between an index and an average is not always clear. As a result, the two terms are often used interchangeably.

If this sounds too technical already, don't worry. When put into layman's terms, the concept of a stock index is not difficult to understand. It is simply an indicator of stock price movements. Each index targets a certain group of stocks and reflects the net result of fluctuating daily values for all stocks in the group.

An index also tracks the number of shares outstanding for companies in the index. Some indexes are broad-based in that they are comprised of many individual stocks (e.g., the Wilshire 5000) and thus are more representative of the overall stock market. Others are more narrowly based, meaning that they track a smaller number of stocks reflecting only a particular industry (e.g., automotive) or segment of the stock market (e.g., small cap stocks). An extensive number and variety of stock indexes exist. The Dow Jones Industrial Average (which includes only 30 stocks) and the Nasdaq Composite Index are two of the most widely followed stock indexes. These and other well-known stock indexes are briefly described below.

One factor to be aware of about a stock index is its methodology for weighting each individual security--in other words, the way in which it determines how much of each individual security to include in the index. Some indexes are weighted by market cap; the companies with the highest total value of stock outstanding make up a larger share of the index than companies with a smaller market cap. As a result, those companies may have a disproportionate impact on the index's performance. Other indexes are weighted by price; the most expensive stocks receive greater weight than lower-priced stocks. Still others are equal-weighted; each company receives the same weight in the index, regardless of size.

How can you use stock indexes?

Stock indexes can have several uses for the individual investor. Most obviously, if checked regularly, they can provide valuable information needed to stay abreast of how the stock market (as a whole or a particular segment) is faring. This can help you make informed investment decisions about when and what to buy, when to sell, and so on. To make the best decisions, though, you should use indexes in conjunction with a variety of other resources. Many investors even invest in investments that track one or more stock indexes in an effort to reduce their risk and/or assure themselves of a particular level of return (though there are no guarantees).

Though it is not possible to invest directly in an index, you can do so indirectly. If you'd like to try to achieve a performance similar to that of a particular index, you can either directly copy the index on your own (by buying all of the individual securities in the index) or purchase shares of an index mutual fund or exchange-traded fund that essentially replicates the index. This latter method is generally easier, safer, and less costly for the average investor. Beyond that difference, though, these two methods of investing in indexes share the same pros and cons. Since most indexes are broad-based in terms of number of securities, they offer the advantage of extraordinary diversification. This typically means that you have an excellent chance to achieve returns that approximate market averages.

However, such investments are not without risk. Depending on market conditions and other variables, the potential always exists that even a widely diversified index-based investment could take a bad tumble; even diversification can't guarantee a profit or protect against the possibility of loss. This could happen, for instance, if an entire industry targeted by a certain index suddenly finds itself out of favor, or if a stock that dominates a particular index has difficulties. However, the diversification of index-based investments can help minimize that impact compared to investing in an individual security. The tradeoff of this diversification is that returns may be diluted as well; the performance of an index's weaker components will be a drag on that of its stronger members. A portfolio that concentrates on the index's best performers could outperform the index.

Finally, selected indexes are also used as the basis for stock index futures, index options, and other instruments that enable investors to hedge against general market movement at a low cost. These latter instruments should be reserved for the most sophisticated investors, however.

Ultimately, there's no right or wrong answer to the question of whether you should put money in index-based investments. The decision is a personal one, based on your own investment objectives, tolerance for risk, and other factors. If you need guidance, consult a financial planner or other professional.

What are some specific stock indexes?

American Stock Exchange Composite Index

The American Stock Exchange Composite Index (abbreviated XAX) is a market capitalization-weighted price appreciation index. This particular index was introduced by the American Stock Exchange (sometimes called the AMEX) in January 1997 and replaced the American Stock Exchange Market Value Index (abbreviated XAM) that had been used since 1973.

Unlike its predecessor, the AMEX does not count dividends when calculating the return on securities in the index. Many investors thought that it was unrealistic to assume that dividends were always reinvested. Thus, the old index gave a somewhat positively skewed picture of the underlying securities' performance.

The AMEX includes a wide variety of securities--common stocks, American depositary receipts (ADRs), American stock exchange-listed companies, real estate investment trusts (REITs), closed-end investment companies, and master limited partnerships. The index computes the aggregate market value of all of these securities (or components) and then compares this number to the value of the same components on the base date of December 29, 1995. Each component's market value is computed by multiplying the number of shares outstanding by the price of that component.

Dow Jones Industrial Average (DJIA)

The Dow Jones Industrial Average (abbreviated DJIA and sometimes called just the Dow) is a price-weighted average of 30 large, blue chip industrial stocks. Companies tracked in the DJIA include AT&T, Boeing, Coca-Cola, Exxon, General Electric, IBM, McDonald's, and other similar well-known, actively traded companies.

The DJIA is calculated by adding the trading prices for all of the component stocks and then using a divisor to calculate the average. The divisor is adjusted to account for stock dividends and stock splits, substitutions and mergers, and cash equivalent distributions equal to 10 percent or more of the closing price for an issue in the average. The average is quoted in points, not dollars. Thus, you may hear a newscaster report that the Dow was up 38 points for the day.

The Dow Jones Industrial Index is the oldest and best-known index of stocks. Its component stocks represent between 15 and 20 percent of the entire market value for all stocks on the New York Stock Exchange. Not surprisingly, many institutional and individual investors use the DJIA as an indicator of changes in prices for the entire stock exchange. Furthermore, for many years, certain investors have used the DJIA as the basis to interpret the Dow Theory, which tries to predict the course of the stock market. Many investors and traders also use the average to formulate trading strategies. Futures on the DJIA are traded on the Chicago Board of Trade, and options on the average are traded on the Chicago Board Options Exchange.

Dow Jones Transportation Average

The Dow Jones Transportation Average (abbreviated DJTA) is a price-weighted average of 20 transportation-related stocks, and is even older than its better-known cousin, the Dow Industrials. The DJTA is quoted in points and not dollars.

The Dow Jones Transportation Average is used in conjunction with the Dow Jones Industrial Average (DJIA). According to Dow

Theory, when both averages reach either new highs or new lows simultaneously for a period of time, they are believed to represent confirmation of a trend in stock market prices. Failure of one index to do so weakens the case for the existence of a trend. As with the DJIA, Dow Jones & Co. (publishers of *The Wall Street Journal*) selects the stocks included in the average and publishes data about its movements and value.

Financial Times Stock Exchange 100 Index

The Financial Times Stock Exchange 100 Index (abbreviated FTSE 100) is a market capitalization-weighted stock index of the top 100 companies in the United Kingdom. The 100 companies are ranked according to their market capitalization. The index is reweighted every day, and, during the day, it is reweighted every minute. The Financial Times Stock Exchange 100 Index is calculated by FTSE International, an independent company wholly owned by the *Financial Times* (a financial newspaper located in the United Kingdom) and the London Stock Exchange. FTSE International reviews the makeup of the index quarterly. Additions and deletions of companies from the index are made strictly in compliance with specific rules supervised by the FTSE Actuaries Share Indices Steering Committee, an independent body.

MSCI Emerging Markets Index

The MSCI Emerging Markets Index is a market capitalization-weighted index of stocks from emerging countries, primarily in Latin America and Southeast Asia. Emerging countries refer to smaller nations whose economies are not as developed or as industrialized as the economies of larger countries. Many of the economies of these emerging countries are growing much more rapidly than those of more fully developed regions. However, these countries are more susceptible to economic setbacks and other problems. Therefore, many of the stocks included in this index tend to be more volatile than stocks in the more developed countries--they often rise faster in good times and fall more rapidly in bad times. In many cases, their economies can be heavily dependent on the prices for commodities exports.

MSCI/EAFE Index

The MSCI/EAFE Index (EAFE is an abbreviation for Europe, Australia, and the Far East) is a market capitalization-weighted index of stocks in major developed countries around the world, besides the United States. Unlike the MSCI Emerging Markets Index, which measures the performance of foreign stocks in smaller emerging countries, the EAFE Index concentrates on stocks in the larger, more industrialized nations of the world. For this reason, the MSCI/EAFE index tends to be less volatile than the Emerging Markets Index. Like many other stock indexes, the index can be useful for gauging the performance of an international stock portfolio.

Nasdaq Composite Index

The Nasdaq Composite Index is a market value-weighted (see definition of "market value" below) index that includes all of the domestic and international common stocks traded on the Nasdaq Stock Market. The index began in 1971 with a value of 100 and includes more than 3,300 stocks.

The market value--the last-sale price multiplied by total shares outstanding--is calculated throughout the trading day and is related to the total value of the index. Each stock in the Composite Index is assigned to a Nasdaq subindex. Several subindexes are categorized by industry--banks, biotechnology, computers, industrials, insurance, other finance, transportation, and telecommunications.

Like many other stock indexes, the Nasdaq Composite Index is used by individual and institutional investors to track the performance of all of the stocks traded on the Nasdaq. Many institutional investors who invest primarily in Nasdaq stocks use this index as a yardstick by which to measure the performance of their portfolios. An individual will also find this index useful to compare performances of mutual funds that invest in Nasdaq stocks.

Nasdaq 100 Index

The Nasdaq 100 Index is a market capitalization-weighted index of the largest and most actively traded nonfinancial stocks on the Nasdaq. This index includes both U.S. and foreign stocks. All stocks in the Nasdaq 100 Index come from the top 125 eligible securities in terms of market value. To be eligible, a U.S. stock must have a minimum average trading volume of at least 200,000 shares per day and must have been listed on the Nasdaq for at least two years. The index composition is reviewed annually, and any necessary replacements of securities in the index become effective after the close of trading on the third Friday in December.

New York Stock Exchange (NYSE) Index

The New York Stock Exchange Index is a market value-weighted index of all of the stocks traded on the New York Stock Exchange. This index is weighted by multiplying the number of shares outstanding for each company by the price of that stock (in other words, the aggregate market value for each company). Any stock splits or stock dividends do not require an adjustment to the index because the aggregate market value of the company will not be affected. For example, if a NYSE-listed company has one million shares outstanding with a per share price of $50, its aggregate market capitalization is $50 million. If the company splits the stock two for one, it will have two million shares selling for $25 per share. Its aggregate market capitalization is still $50 million.

An adjustment to the index may be necessary if a new company is listed on the exchange or if a company is delisted. Also, an adjustment to the base amount of the index may be needed if a listed company merges with a company not listed on the New York Stock Exchange. The base date for the New York Stock Exchange Index is December 31, 1965. The index was first published in July 1966.

Russell 3000 Index

The Russell 3000 Index is a market capitalization-weighted index of the 3,000 largest companies in the United States. It is compiled and published by the Frank Russell Company in Tacoma, Washington. The 3,000 stocks in this index represent about 98 percent of the U.S. equity market.

The Frank Russell Company also breaks down this particular index into two other major equity indexes--the Russell 1000 Index, which measures the performance of the top 1,000 stocks in the 3000 Index and represents about 10 percent of the 3000's market cap, and the Russell 2000 Index, which measures the performance of the 2,000 smallest companies in the 3000 Index. Both of those indexes also are market capitalization-weighted.

Standard & Poor's 500 Composite Index

The Standard & Poor's 500 Composite Index (often abbreviated as simply the S&P 500) is a market value-weighted index of 500 widely held common stocks. It is compiled and published by the Standard & Poor's Corporation, a financial advisory, securities rating, and publishing firm.

The S&P 500 Index tracks the performance of industrial, transportation, financial, and utility stocks. Currently, the companies in the index represent between 85 and 90 different industry groups. Most of the companies included in the index are large capitalization stocks traded on the New York Stock Exchange and the Nasdaq stock market.

In total, the capitalization of the stocks in the S&P 500 includes about 75 to 80 percent of the total capitalization of all stocks traded on the New York Stock Exchange and about 70 percent of the total capitalization of all U.S. equities. In contrast, the stocks in the Dow Jones Industrials Average represent only about 20 percent of the total capitalization of all U.S. equities. Thus, the S&P 500 Index is a much broader and more representative index of the U.S. equity markets than is the Dow Jones Industrial Average.

Standard & Poor's 400 MidCap Stock Index

The Standard & Poor's MidCap Stock Index (often abbreviated as the S&P 400 Index) is a market value-weighted index of 400 Mid Cap companies. Stocks for the S&P 400 are selected by the Standard & Poor's Corporation based on their market size, liquidity, and industry group representation. "Mid Cap" refers to the market capitalization of a company--the number of shares outstanding multiplied by the share price. Stocks are generally categorized into three broad market capitalization classes: Small Cap (usually under $900 million in market capitalization), Mid Cap ($900 million to $3 or $4 billion in market capitalization), and Large Cap (over several billion dollars in market capitalization).

The S&P 400 Index measures the stock market performance of Mid Cap companies in four broad sectors of the economy: industrials, utilities, financials, and transportation. As of June 2003, approximately 11 percent of the companies in the S&P 400 Index fell into the industrials group, over 21 percent were in the consumer sector, info tech and telecom made up just under 16 percent, almost 14 percent were in the utilities and energy sectors, nearly 20 percent were financial stocks, about 4 percent were in materials, and 14 percent were in the healthcare group. A majority of the S&P 400 Index companies trade on the New York Stock Exchange, with the remainder trading on the Nasdaq and the American Stock Exchange.

Standard & Poor's 100 Stock Index

The Standard & Poor's 100 Stock Index (usually abbreviated OEX after its ticker symbol) is a market capitalization-weighted index of 100 large companies. These firms are also included in the Standard & Poor's 500 Stock Index. Although the S&P 100 Index contains only one-fifth of the stocks in the S&P 500 Index, it is actually about one-half the size of the larger index in terms of its market capitalization (i.e., it includes most of the largest companies in the 500 Index).

The stocks in the S&P 100 are predominantly industrial companies, but some utility, transportation, and financial companies are also included. Initially, the S&P 100 Stock Index was called the "CBOE" (Chicago Board of Options) 100. The index was created by the CBOE in 1983 so that options (both puts and calls) could be traded on an index whose performance mirrored that of large companies in the U.S. equity markets.

TSE 300 Composite Index

The TSE 300 Composite Index is a broad index of 300 Canadian stocks that trade on the Toronto Stock Exchange, the largest in Canada. The TSE 300 is the most widely used and most frequently quoted index tracking this stock exchange. It is created and maintained by the Toronto Stock Exchange. For a company to be included, it must be incorporated under Canadian federal, provincial, or territorial jurisdictions, and it must be listed on the Toronto Stock Exchange. In addition, the exchange sets other requirements for companies to be included in the index (e.g., minimum trading volume, minimum listing period, minimum float). Certain financial instruments, such as limited partnerships, royalty trusts, real estate investment trusts, and other instruments deemed not appropriate by the stock exchange are not eligible for inclusion in the index. Many institutional investors who purchase Canadian securities use this index as a performance benchmark to measure their own portfolios.

TSE 100 Index

The Toronto Stock Exchange 100 Index (or TSE 100 Index) includes 100 large Canadian companies that trade on the Toronto Stock Exchange, and is created and maintained by that exchange. The 100 stocks included in the TSE 100 Index must also be included in the TSE 300 Composite Index. Any company in the TSE 300 Composite Index is eligible for the TSE 100 Index, as long as its aggregate trading value for the previous 12 months ranks within the top 150 of the TSE 300 Composite Index. The TSE 100 Index is used as a performance benchmark by many large institutional investors who invest in Canadian securities. The index may also be used by individual investors who want to compare and contrast the performance of mutual funds that invest in large-capitalization Canadian stocks.

Value Line Composite Average Index

The Value Line Composite Average is an equally weighted geometric average of 1,700 different stocks, compiled and maintained by Value Line (publishers of the Value Line Investment Survey and other investment information). Most of the 1,700 stocks in the index are traded on the New York Stock Exchange, but some are traded on the Nasdaq and American Stock Exchanges as well. About 1,500 industrial companies are in the index, with the remainder of the stocks split unequally between the utility and transportation sectors.

Although the Value Line Composite Average is technically an average, it closely resembles an index. It uses a base value of 100, established in 1961. Changes in the average are expressed in index numbers rather than dollars and cents. The average is designed to chart the price changes of a wide variety of stocks in many different industries--unlike the Dow Jones Industrial Average, which reflects price changes in the stocks of only 30 large industrial companies.

Wilshire 5000 Total Stock Market Index

The Wilshire 5000 Total Stock Market Index is a market capitalization-weighted index of more than 5,000 U.S.-headquartered equity securities. This index includes virtually all of the U.S. equity securities for which prices are readily available and thus represents one of the broadest measures of the U.S. stock market.

Among the equity issues included in the index are common stocks, real estate investment trusts (REITs), and master limited partnerships. Because almost all of actively and semiactively traded securities are included in the Wilshire 5000 Total Stock Market Index, it is considered one of the broadest and most representative of all U.S. equity indexes. Additions to and deletions from the index are generally made monthly.

Technical Note: *The index was published for a time in association with Dow Jones and was known as the Dow Jones Wilshire 5000 Index. However, after March 31, 2009, it reverted to its original management by Wilshire Associates in California. The Dow Jones equivalent index is known as the Dow Jones Total Stock Market Index.*

Bond indexes

In addition to stock indexes, there are several different bond indexes. These indexes are aggregate measures that track the bond market or particular segments of it. The various bond indexes are compiled and published by bond-rating agencies, the Federal Reserve Board, brokerage firms, and financial publications. Like stock indexes, most of the bond indexes use a limited number of bond issues to chart the price movement of a larger universe of bonds. There are composite bond indexes that measure the price movement of a wide variety of bonds. There are indexes that measure the price of municipal bonds, some that chart the price movement of utility bonds, and numerous others that cover the entire spectrum of available bonds.

Most bond indexes measure either the underlying price movement of the bonds in the index and/or the fluctuating yields of the bonds. Many bonds are issued in denominations of $1,000 with a set yield (i.e., the bond issuer will pay a set amount of interest each year until maturity). The price of the bond will then fluctuate in the marketplace as interest rates for similar bonds rise or fall. If interest rates fall after the issuance of a bond, the price of the bond will rise (so the yield on that bond will be comparable to other similar bonds in the marketplace).

Similarly, if interest rates rise, the price of the bond will fall. This is commonly referred to as the inverse relationship between interest rates and bond prices. How much the bond price will rise or fall depends on the length of the maturity, the bond rating, and other factors. Many of the bond indexes, therefore, track the actual underlying price movement of the bonds, although some will directly track bond yields. Other bond indexes compile and publish both the bond prices and the corresponding yields.

How can you use bond indexes?

Many investors use bond indexes to follow broad trends in the various bond markets. Institutional bond investors often use the indexes as a benchmark against which to measure their performance. For example, an institutional bond fund manager who invests in municipal bonds may use one of the municipal bond indexes to measure his or her performance. Similarly, an individual may use a bond index to compare and contrast performance on bond mutual funds.

In addition, some investors believe that bond indexes may be used as indicators of stock price trends. Historically, there tends to be an inverse relationship between bond yields and stock prices--when bond yields go down, stock prices go up. Stock investors therefore sometimes study bond indexes to try to discern trends in the price and yield movement of bonds.

What are some specific bond indexes?

Dow Jones Composite Corporate Bond Average

The Dow Jones Composite Corporate Bond Average is a composite average of 10 public utility and 10 industrial bonds. The Dow Jones Company selects the public utilities and industrial companies whose bonds are included in the average. The public utilities included in the average are some of the largest and most financially stable utilities in the United States, such as Commonwealth Edison, New York Telephone, Pacific Bell, and Potomac Electric. These utilities range from telephone companies to electricity providers to natural gas companies.

Industrial companies included in the average are some of the largest blue chip industrial companies in the country, such as Du Pont, AT&T, IBM and other similar companies. All of the public utility and industrial bonds in the average are highly rated and very safe debt instruments.

Many bond investors use the Dow Jones Composite Bond Average as an analytical tool when investing in the bond market. A large institutional investor in bonds may use the average as a benchmark for performance. An individual investor may want to compare the performance of this average with that of a bond mutual fund, for example. One note of caution: The bonds included in this average tend to be high-quality, financially secure debt instruments. It may not be appropriate to compare the performance of a high-yield (or "junk") bond fund with this average.

Dow Jones Bond Averages

In addition to the Composite Corporate Bond Average, Dow Jones publishes separate subaverages of the 10 utility bonds and 10 industrial bonds that make up the composite average. The utility bonds tend to be those of large, financially stable, well-known utilities, such as Consolidated Edison, PG&E, and other similar companies. The industrial bonds are, again, those of large companies such as Du Pont, AT&T, IBM, and other Fortune 500 companies. The utility bonds and the industrial bonds included in the index have a variety of maturity dates, ranging from a few years to 10 or 15 years.

Dow Jones also publishes a government bond index made up of 10 different government bonds. Like the utility and industrial bond indexes, the bonds in the government bond index have a variety of maturity dates.

Many institutional and individual bond investors use the Dow Jones bond averages as analytical tools. For example, a large institutional bond investor may use the Industrial Bond Average as a benchmark against which to measure his or her performance in the bond market. An individual investor may use these averages to compare and contrast the performance of mutual funds that invest in similar types of bonds.

One note of caution: The bonds selected for these bond averages tend to be high-quality, highly rated debt instruments. It may not be appropriate, therefore, to compare the performance of a high-yield (or "junk") bond fund with these averages.

Barclays Capital Aggregate Bond Index

Formerly the Lehman Brothers Aggregate Bond Index, the Barclays Capital Aggregate Bond Index (sometimes abbreviated as "Barcap") is a broad-based bond index composed of a total of more than 6,000 individual bonds. Most are investment-grade, fixed-income securities issued exclusively in the United States, since foreign bonds are generally considered too risky for this index. Bonds in this index can be classified into three major categories: (1) U.S. Treasury bonds and government agency securities, (2) high-grade corporate bonds, and (3) mortgage-backed securities, with maturities of greater than 1 year. This is one of the best-known bond indexes.

Commodities indexes

The commodities indexes measure the price (or performance) of physical commodities such as oil, gold, silver, wheat, and similar goods. The futures indexes measure the prices of these physical commodities by measuring the price of futures contracts on the underlying commodities. Because of the difficulties in actually buying and holding many of these commodities, most individuals and institutions that want to invest in these commodities purchases futures contracts. You can purchase futures contracts on individual commodities; you can also purchase futures contracts on the indexes themselves.

A variety of commodity and futures indexes are compiled and published. Three main commodity indexes measure industrial performance and the price of raw commodities: the Journal of Commerce Index, the Reuters Index, and the Economist Index. There are several major futures indexes used by investors. The futures indexes vary depending on the commodities included in the index and the way that the futures contracts are weighted within the index.

To schedule an appointment with Faye Sykes, click here .

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