The death of the Dow

Last Tuesday, the Wall Street Journal reported that the S&P 500 index dropped 2.1 percent and that the Dow Jones Industrial Index lost 626 points. Interpreting the drop in the S&P index is easy. If you had a portfolio of stocks designed to move with this index, and if your portfolio was worth $100,000 on Monday, you would have lost $2,100 on Tuesday, leaving you with $97,900 on Tuesday. The value of your portfolio dropped 2.1 percent. Easy-peasy.

Interpreting the drop in the Dow is more difficult. What the heck does a 626-point drop mean? Few people know. Interpreting a 600-point drop was easy back in 2001 when the Dow Jones Industrial Index was around 10,000 points. Every 100-point movement represented a 1 percent change in the index.

But the Dow did not stay at 10,000 points for long. Since 2001, it has been trending upwards. This implies that every year, a 100-point change in the Dow will represent a different percentage change in the index. These differences have been substantial. Recently, on the last trading day before Tuesday's bad day on Wall Street, the Dow closed at 41,563.08. So, a 100-point movement only represented a 0.24 percent change in the value of the index. That is about a fourth of what a 100-point drop caused in 2001. How do people keep track of what a 100-point change in the Dow means? I suspect they don't.

The difficulty people have in interpreting a 100-point movement in the Dow should lead to several changes. First, news outlets will probably start reporting the Dow's performance by discussing changes in percentages, not in points. If this change had already happened, then the headline on Tuesday would have been that the Dow Jones Industrial Average decreased by 1.5 percent, not that it decreased by 626.15 points.

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Second, news outlets will probably stop giving such prominence to changes in the Dow. After all, it is a lousy measure of how the broad stock market is doing. The Dow only contains price information about 30 firms. If one of these firms has an exceptionally bad day, perhaps because its very capable CEO unexpectedly quits, that firm will see a large drop in its stock price. This one distressed stock will drag down the Dow by quite a bit since the index only has 30 firms. In contrast other indexes are calculated using many more firms, so they will barely be affected by what happens to a single firm. The S&P 500 index, quite obviously, has 500 firms. The Russell 2,000 Index, just as obviously, uses 2,000 firms. The Nasdaq Composite is calculated by using the stock prices of all of the firms that trade on the Nasdaq stock market. By including many firms, these indexes will do a better job than the Dow at summarizing how the whole stock market performs. Because they include so many firms, these other indexes will not be greatly influenced by an event that affects only one firm (like a CEO quitting). The Dow, as we already said, will be affected.

The Dow Jones Industrial Average goes back to the 1800s. It became well known, so its value had meaning to many people. However, its heyday has passed. The Dow will become obsolete because people will start using alternatives. They will start doing this for two reasons. First, the point changes in the Dow that they have been accustomed to hearing about are becoming increasingly hard to interpret and will mean different things from year to year. And second, these alternatives, like the S&P 500 index, provide a better picture of how the stock market is performing. These other indexes use price data from many more firms than the 30 used by the Dow. The larger a sample gets, the more accurately the sample will represent a population of data. Because of computers, calculating indexes with large numbers of firms has become easy and cheap. We no longer need to worry about whether the cost of calculating indexes will increase when the index has more firms. This was a concern in the 1800s when the Dow was created, but today it is irrelevant. In short, the Days of the Dow will soon be over.

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