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Trio of flaws prevents Dow 250,000

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NEW YORK (CBS.MW) -- You've probably heard of Dow 36,000 -- which was the enticing title of a recent popular book -- but what about Dow 250,000?

"Over time, who cares about stock prices? You want to know what happened to your money!"
John Shoven, Stanford University

That is where a couple of economists say the Dow Jones Industrial Average would be today if only it incorporated dividends in its measurement of stock price changes.

Stanford University economists John Shoven and Clemens Sialm have made a comprehensive study of the Dow Jones Industrial Average and conclude that it has three basic flaws.

"First, each company in the index is weighted by the price of its stock," the study says. "The importance of each company in the index does not depend on its total market capitalization (a measure of size). Instead, a highly priced stock has a weight higher than a lower priced stock. Each time a company in the DJIA splits [its stock], the weight of this company decreases because the stock price falls."

A second flaw is that the 30 companies in the index are not representative of the market as a whole. "[They] are chosen more or less arbitrarily by the Dow Jones & Co. to represent different industries, but they are not chosen according to fixed or defined rules," the report continues, arguing that a more representative index would include a much larger number of companies.

Third and most important, the Dow Jones Industrial Average does not include dividend payouts. This can grossly underestimate a stock's performance.

Hazards of ignoring dividends

If dividends had been included, the economists reckon, the Dow Jones Industrial Average today would not be about 11,000 -- as it is -- but indeed just above 250,000. In their words, "If a stock index is used to gauge the return earned by market participants over long periods of time, a total return index would be far superior to a stock price index."

Shoven admits his study's criticisms aren't completely original, but says many investors don't pursue total return indices because they're hard to find.You can get them online at Morgan Stanley Dean Witter and Standard & Poor's -- S&P has a total return index separate from its more famous 500.

While the Dow Jones Industrial Average is the most obvious example, the Standard & Poor's 500 and all other stock indices also ignore dividend payouts. This is a major defect, say Shoven and Sialm, because investors gain from both price appreciation and dividend payments.

The dividends of the 30 stocks in the Dow have averaged just under 5 percent annually since the modern shape of the DJIA was set in1928. But dividends have been as high as 9.7 percent in 1950 and as low as just under 2 percent in 1998.

Lessons to be learned

Neglecting dividends, say Shoven and Sialm, leads to enormous understatements of the long-run payoff of owning stocks. Shoven likens it to gauging the worth of a real estate investment: Say you bought an apartment house and later got an offer to sell it. You couldn't measure tell if the offer was a good deal simply by comparing the offering price with the price you had originally paid. You would also have to add in the rent you had earned in between.

The analogy has a practical application for investors trying to compare how big American stocks are faring versus those in Japan, says Shoven. Since DJIA stocks pay higher dividends than those on the Nikkei, price change alone doesn't make for a reliable comparison.

We can draw several lessons from this. First, most stocks that you own have enriched you more than you think -- just add in the dividends. Second, most Nasdaq stocks have performed less well than you think against Big Board stocks because very few Nasdaq issues pay dividends of any size. Third, it it's time to reform the indexes, so that they do include dividends.

As Shoven says of the Dow: "It's an OK index of stock prices, but over time who cares about stock prices? You want to know what happened to your money!"