



Market Trends

Hold The Champagne

Michael Maiello, 09.27.06, 12:50 PM ET

The Dow Jones industrial average is trading a whisker below its record high of 11,722.98, set Jan. 14, 2000, while the Standard & Poor's 500, a broader gauge that tracks 85% of the stock market, is around a five-year high. No surprise. The Dow and the S&P tend to move in the same direction at different speeds. The Nasdaq ... let's not even talk about the Nasdaq ... is still in its post-bubble funk.

As for the Dow--never mind the hoopla.

John B. Shoven, the director of the Stanford Institute for Economic Policy Research, pointed out a serious problem with the Dow, and with all price indexes, back in 2000 in a paper called "The Dow Jones Industrial Average: The Impact of Fixing Its Flaws." Were the Dow to include its dividend returns, it would have been at over 250,000 back then. Right now, he says, that number might be 300,000.

"I've heard people say the Dow hit 1,000 in 1965, and it didn't get back until 1981," Shoven says. "Sixteen years and no return. But that's not true. Dividend rates were pretty high, around 4%."

This fixation on the daily price numbers doesn't say much about people's portfolios. During that 16-year period of stagnation, for example, investors were still best served by staying in the stock market. The bond markets, after all, were in shambles during the high inflation of the 1970s.

"The gross domestic product of the United States makes records pretty much every year, so you kind of expect of expect the stock market to always hit records," Shoven says. With inflation of 2% to 3%, the market should climb by at least that amount over the long term, he adds. "Twenty years from now, the Dow won't be at 11,000--it'll be higher. That doesn't mean that I'm predicting the market will do great."

It's not even clear that the Dow truly even represents the market. It's just 30 big stocks like Alcoa, General Electric, and JPMorgan Chase that are in the sweet spot of a market segment that's been doing well lately: large companies. According to Dow Jones' most recent component report, 18 of its names are value stocks, meaning they seem inexpensive relative to their assets and earnings. The Dow lists eight growth stocks, which have expanding profits, though some of those names, like Intel and Wal-Mart Stores, aren't exactly the frothiest of growth issues these days.

Gus Sauter, chief investment officer for Vanguard, which offers index funds that track the S&P 500 and even broader swaths of the stock market, thinks of the Dow in the way he thinks of specialty indexes that track small-company stocks or specific industries. "It doesn't capture the entire market because it tends to have a value bias. This doesn't mean that investors overall are hitting highs."

The Dow is so popular because it's the first of the stock indexes. Charles Dow of Dow Jones started it in 1884 with 11 stocks. The index still represents a bit of an Industrial Revolution view of the American economy, heavily weighted toward big manufacturing companies. The Dow tends to appreciate more quickly than the S&P when value stocks are in favor, and tends to lag when

growth stocks rule. That it's the first major index to break records since 2000 is no surprise, as value investors have been cleaning up of late.

But it would be good to keep the advance in perspective. "I remember a lot of fanfare when the Dow went through 10,000 for the first time," Sauter says. "We're really not much higher than 10,000 now."

It's a happy number, though, so let's end with a happy thought. With stocks trading at around 17 times earnings (compared with 34 times earnings in 1999), neither Shoven nor Sauter thinks that this is a market bubble.