Understanding Market Indexes

Index funds allow individual investors to do what many corporate pension fund managers have accomplished successfully for years: invest passively in diversified stock portfolios that closely match the performance of major market yardsticks.

In general, the funds that track indexes of larger capitalization stocks (such as the S&P 500) provide moderate growth with relatively low risk. In contrast, indexes of smaller capitalization stocks (for example, the Russell 2000) should demonstrate faster growth but greater volatility.

The index fund approach has two distinct advantages:

- First, it provides a high degree of performance predictability relative to the market as a whole and second, it does this at low cost. Expenses are low because management advisory fees generally are modest.
- And since fund holdings are turned over infrequently, capital gains distributions, commissions costs and operating expenses are low, enhancing net returns to shareholders.

Index funds have their drawbacks:

- In a slumping market, a passive strategy may fare worse than that of a conventional fund whose manager builds up a large cash reserve. However, index funds represent a relatively conservative investment option for those who are willing to ride out unpredictable market swings in expectation of long-term appreciation.

Various indexes that measure the performance of the U.S. Market range from the broadest perspective to a narrow look at a single industry. Still other indexes track foreign stock markets. Several major domestic indexes are profiled below with information from Standard and Poor's.

S & P COMPOSITE INDEX | When investment professionals want a proxy for the general market, they usually turn to the S&P 500. As the name indicates, the index consists of 500 U.S. issues, which represent about 70 percent of the total market value of American stocks. The 500 is capitalization-weighted, meaning that stocks influence the index in proportion to their importance in the market. The S&P 100 is simply the top 20 percent of the 500.

DOW JONES INDUSTRIAL AVERAGE | The oldest measure of market performance, the DJIA took its modern form of 30 large-capitalization stocks in 1928. The original version of Charles Dow's average, which consisted of only 11 stocks (nine of them railroads), first appeared in 1884. Originally the average price of a set of stocks, calculation of the DJIA has been changed over the years to reflect stock splits and substitutions. To make historical comparisons valid, the sum of the stocks in the Dow is no longer simply divided by 30. Today, the divisor is 0.559.

Two other market averages from Dow Jones track specific sectors. The Transportation average is composed of 20 airline, railroad and trucking companies, while the Utility average consists of 15 gas and electric companies. All three averages are included in the Dow Jones 65 Stocks Composite. None of the Dow averages is capitalization-weighted and each has its own divisor.

NYSE COMPOSITE INDEX | This index measures the aggregate change in the value of all common stocks listed on the New York Stock Exchange. The base value was set at 50 as of year-end 1965. (That value was chosen because it was close to the average price of a NYSE-listed share at the time.) Four sub-indexes of NYSE-listed stocks are also tracked: Industrial, Transportation, Utility and Finance.

AMEX MARKET VALUE INDEX | Established in September 1973, the AMEX Market Value Index measures the change in value of roughly 1,000 issues traded on the American Stock Exchange. Included are common shares, ADRs and warrants. The Amex index has eight industry subgroups and another eight geographic subgroups, the latter reflecting corporate headquarters locations. The Market Value Index treats cash dividends as reinvested, thereby providing a picture of the total return for Amex stocks.

NASDAQ COMPOSITE INDEX | This is a measure of all OTC (Over The Counter) issues (except warrants) traded on the NASDAQ National Market System (NMS) and all domestic non-NMS common stocks traded in the regular NASDAQ market. The composite and its six sub-indexes (Industrial, Banks, Insurance, Other Finance, Transportation and Utilities) are market-value weighted. (Large companies move them more than smaller companies.) Cash dividends are not counted in the indexes. The NASDAQ Composite and its sub-indexes were established in 1971.

RUSSELL 1000, 2000, 3000 | These indexes were developed by the Frank Russell Company to track the 3000 most actively traded U.S. shares. The Russell 3000 contains all of the issues, is capitalization-weighted and represents about 99 percent of the stocks held in institutional portfolios. The 1000 is the top tier of the domestic market and the 2000 represents the second tier.

WILSHIRE 5000 | Although called the Wilshire 5000, this index actually tracks the value of more than 6,000 domestic stock issues. Established in 1974 by Wilshire Associates, this capitalization weighted index is designed to represent the total value of the U.S. market.

S & P MIDCAP 400 | The newest addition to the index universe is the S&P MidCap 400, which was launched in recent years. Designed to track that segment of the market just below the 500, the S&P MidCap 400 is a market-weighted index. Unlike the 500, the S&P MidCap 400 has no industry sub-indexes.