

Looking Beyond the Dow

Overview: Many investors use the Dow Jones Industrial Average as a gauge of how the market is doing. It is important to recognize that the Dow only captures one portion of the market.

How did the market do today? When is the market going to get back to 14,000?

When investors talk about “the market,” they usually mean the Dow Jones Industrial Average. A well-educated investor recognizes that the Dow is *a* market, but it is not *the* market.

What is the Dow? The Dow is an index composed of 30 U.S. stocks chosen to indicate how the stock market is doing. The Dow does a good job of measuring the performance of one asset class — U.S. large-cap growth. The same could be said of the S&P 500 Index, which is composed of 500 of the largest U.S. companies. It is also commonly used to represent “the market.”

There are mathematical reasons why investors view the Dow as the market. Even though the Dow only tracks a small fraction of the companies in the market, those companies make up roughly 25 percent of the market. The S&P 500 provides about 75 percent coverage of U.S. equities.

However, solely considering the Dow (or the S&P 500) as the market can lead to a wrong view of performance. Just look at the past decade. The 10-year annualized return of the Dow was 1.3 percent, and it was –1.2 percent in real terms. So this was a decade of lost market returns, right?

Wrong! Consider the following table.

Annualized Returns (%) 2000–2009			
U.S.	Returns (%)	International	Returns (%)
Large-Cap (Dow)	1.3	Large-Cap	1.2
Large-Cap (S&P 500)	–1.0	Large-Cap Value	3.5
Large-Cap Value	2.5	Small-Cap	4.3
Small-Cap	3.5	Small-Cap Value	11.6*
Small-Cap Value	8.3	Emerging Markets Large-Cap	9.8
Real Estate	10.7	Emerging Markets Small-Cap	10.9
		Emerging Markets Value	12.1

* As represented by Dimensional Fund Advisors’ small-cap value index.

So was this a decade of lost returns? No. Consider a globally diversified stock portfolio with a 50 percent domestic and 50 percent international allocation, equal weighting of the five domestic equity asset classes (10 percent each) and equal weighting of the international equity asset classes (10 percent each, then 3.33 percent for each of the emerging market classes). This portfolio, rebalanced annually, had an annualized return of about 6.1 percent over the past 10 years.

Having a Plan

While there have been 10-year periods when the returns for each of the markets mentioned in the table were better, a well-educated investor with a good advisor may have experienced slightly better returns. How could that be?

Such returns do not appear every year. There are peaks and valleys in the performance of each of those asset classes. In most cases, those peaks and valleys occur at different times. Well-educated investors with good advisors should have portfolios with the appropriate amount of exposure to each of those asset classes, according to their well-designed Investment Policy Statement.

Advisors should be monitoring the portfolio throughout the year in case asset classes grow out of their allocation range. When that occurs, investors should have the discipline to sell some of the asset classes that are above their target allocations (at high prices) and then buy the asset classes that are below their target allocations (at low prices) to rebalance their overall plan. (After all, the golden rule of investing is to buy low and sell high.) This strategy involves buying more shares when prices are low, improving the portfolio growth over time.

Summary

Ten years is a short time period, and there is no crystal ball to predict the future. Still, investors should look beyond the Dow when they think of the market and their investment portfolios. When looking back, it is clear that there are benefits to having a globally diversified portfolio rebalanced and tailored to investors' willingness, need and ability to take risk.

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