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Keeping Up With the Dow Joneses

By JUSTIN LAHART

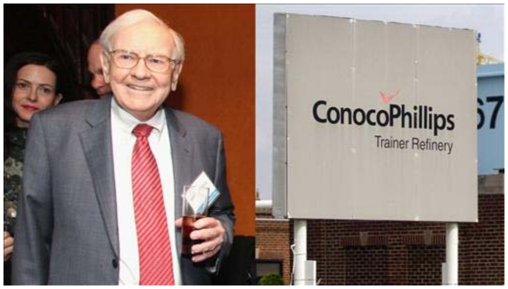
Knowing heads will tell you that the Dow Jones Industrial Average's record close doesn't count for much.

Do soaring markets correlate to a stronger economy or proof of a successful monetary policy? Heard on the Street's Justin Lahart discusses on Markets Hub.

The Dow is, after all, just an arcanely constructed measure of a rather arbitrary collection of 30 stocks. To take it as a reflection of the U.S. stock market seems silly.

Ask these sages how much the market went up on Tuesday, and they'll probably tell you, "126 points."

Related Video

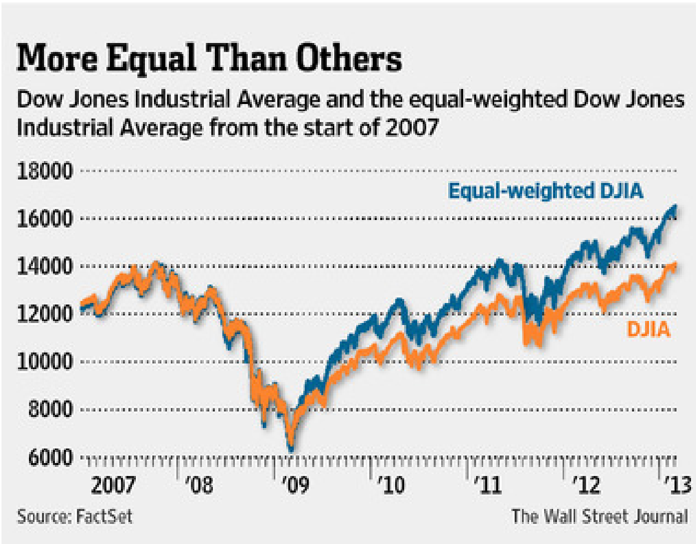


Warren Buffett of Berkshire Hathaway is recognized as one of the the most successful long-term investors of all time. MarketWatch's Laura Mandaro looks at Buffett's long equity positions as of the end of December 2012. (Photo: Getty Images)

The fact is that historically, the Dow hasn't been a bad measure of stock-market performance. Even though it is oddly put together, with each company in the index weighted by the price of its stock rather than its stock-market capitalization, it has tended to trade alongside broader market measures, like the S&P 500. A 2000 paper in the Journal of Wealth Management by John Shoven and Clemens Sialm found that from 1928 to 1999, a cap-weighted Dow wouldn't have put in a markedly different performance from the actual Dow industrials.

Which isn't to say that there aren't some vitally important aspects of the market that the Dow industrials, and most other measures, miss.

There is, for example, the impact of inflation, which makes today's Dow worth considerably less than it was on Oct. 9, 2007, when it last hit a record. Adjusted for inflation since then, the Dow industrials would only be around 12,900 instead of Tuesday's closing level of 14,253.77.



But that inflation impact is more than offset by the fact that any investor who held the Dow industrials would have been gathering dividends over the past 5½ years. With dividends reinvested, the Dow would now be at 16,600. Adjusting for both inflation and dividends would put the Dow industrials around 15,000.

Another consideration is that while it is called the Dow Jones Industrial Average, it doesn't really reflect how well the average stock is doing. In cap-weighted indexes like the S&P, stocks with high market capitalizations, like Apple, are worth more than others. In the same way, as a price-weighted index, some Dow industrials stocks like International Business Machines, are worth far more than the others.

And it turns out that just as the stocks with the largest weightings in the S&P—which historically have tended to be more richly valued than others—have tended to weigh on that index, stocks with the largest weightings have tended to weigh on the Dow.

Put all stocks on the same footing since the Dow's old record, and the index would have performed much better: The equal-weighted Dow now stands at 16,683.44—2,518.91 points, or 17.8%, higher than its 2007 high of 14,164.53.

The Dow industrials may be as good a benchmark as any other, but investors whose portfolios aren't beating it should do some hard thinking.

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