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**The Dow puffs on - Stockmarket indices**

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Stockmarket indices

America's most famous stockmarket index is also its most peculiar

SINCE the height of the railroad age, the Dow Jones Industrial Average has tracked the fortunes of a select group of America's corporate leviathans. Many in the markets think the Dow is no more modern than a steam locomotive. But the index still holds some resonance. Witness the ballyhoo on January 9th when it closed above 11,000 for the first time since June 2001, although it was still 6% below its all-time high.

Lots of people watch the Dow. Some also bet money on it.The Diamonds Trust, an exchange-traded fund, lets investors buy the index, more or less. The trust provided a meagre pre-tax return of 1.53% in 2005.

Most fund managers, though, judge themselves against the S&P 500 index, which returned a few percentage points more than the Dow last year, but is still 15% below its peak.

The Dow is an anachronism. Despite its name, it is no longer wholly industrial (J.P. Morgan Chase has never made a widget) but it does still resemble an average. Charles Dow, its inventor, first published his index in 1896 by simply adding up the price of 12 stocks and dividing by 12. The calculation is now a little more sophisticated—it takes some account of stock splits, big dividend payouts, and the reshuffling of its pack, now of 30 companies—but it still bears the influence of Charles Dow's finger-exercise. The companies with the highest share price, not the biggest market capitalisation, still carry the most weight. As a result, Alcoa counts for more than Microsoft, a company ten times as large.

Much has been made of this flaw, but it makes surprisingly little difference in practice. In 2000 John Shoven and Clemens **Sialm** of Stanford University redid the Dow, weighting each company by its market heft. The real Dow became a 30-strong index in October 1928 at 239.43 points and ended 1999 at 11,497. From the same starting position, Mr Shoven's and Mr **Sialm**'s version reached 12,212. Their Dow outperformed its cruder cousin in 429 out of 855 months and underperformed in 426.

However the Dow stacks its blue chips, there are simply too few of them on the board. Thirty companies is too small a number to diversify away the idiosyncratic risks associated with each one. The Dow's triumph this week was actually a reflection of this handicap. General Motors, the ailing carmaker, enjoyed a rare good day—a Goldman Sachs report suggested that the company is not quite as sick as everyone assumed. And because GM accounts for 1.6% of the Dow, compared with 0.12% of the S&P 500, the Dow is sharing more of the carmaker's highs and lows than it needs to.

The Dow is notoriously slow to shuffle its pack. This conservatism has little economic rationale. Industrial change does not respect past pedigree, otherwise National Lead and Distilling & Cattle Feeding, two of the original 12 stocks, would still be proud members.

And yet the alternatives have their imperfections too. The S&P 500's members are shuffled more often, and according to so many criteria, that some money movers complain they are batting against something resembling an actively traded fund, not a passive index. In particular, in its quest to remain representative of the American stockmarket, the S&P 500 will admit companies riding high on a wave of irrational exuberance, which pushes newly promoted stocks still higher. Philip

Cusick, of Bear Stearns, has found that companies invited into the index enjoy an abnormal jump in the price of their stock, which averages 4.34% between the day their inclusion is announced and the end of the next trading day.

So is the Dow a relic? It rides on a narrower gauge than its newer rivals. But it is not yet bound for the scrapyard.

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