

An Index Overview

Part 3: Index Mechanics

Market indexes. You read about them all the time, such as when the Dow Jones Industrial Average (the Dow) topped 35,000 points in July 2021. In our last piece, we explored what those points actually measure, which isn't always what you might guess. Today, we'll take a closer look at the mechanics of indexing, to gain a better understanding of why they do, what they do.

The Birth of Indexing

When you hear the term "stock index," you're not alone if the first thing that comes to mind is the **S&P 500**; some of the world's largest index funds are named after it. Despite its familiarity, the S&P 500 is a babe in the woods compared to the world's first index — the Dow.

As described in *Capital Ideas* by Peter Bernstein:

"The first Dow Jones Average appeared in the Afternoon News Letter on July 3, 1884. It consisted of the closing prices of eleven companies: nine railroads and two industrials. [Charles] Dow's idea was to provide an overall measure of the performance of active companies, at a time when an average day's activity on the New York Stock Exchange was about 250,000 shares."

Eleven companies, nine of them railroads, wouldn't make for much of a market proxy these days! And yet the Dow still only tracks 30 stocks, as it has since 1928. Plus, it still uses mostly the same methods for tracking them. James Mackintosh, a senior columnist for *The Wall Street Journal* (the effective birthplace of the Dow) says: "It's time to ditch the Dow. After 120 years, the venerable Dow Jones Industrial Average is an embarrassing anachronism, abandoned by professionals and beloved only by a media that mostly knows no better. It needs to be updated or, better, replaced."

And yet, despite its flaws, the Dow persists. Markets are made of people, and people can be sentimental about their past. More pragmatically, the Dow serves as a

time capsule of sorts, offering historical perspective no other index can match. It's also just plain familiar.

How Do Indexes Get Built?

What about all those other indexes? New ones come along whenever an indexer devises a supposedly better mousetrap for tracking market performance. If enough participants accept the new method, an index is born.

That's our free markets at work, and it sounds simple enough. But if we take a closer look at the various ways indexers track their slices of the market, what may seem clear at a glance is often seething with complexities. Here are a few of the ways various indexes are sliced and diced.

Weighting

How much weight should an index give to each of its holdings? For example, in the S&P 500, should the returns delivered by Emerson Electric Company hold the same significance as those from Apple Inc.?

- The Dow is **price-weighted**, giving each company more or less weight based on its higher or lower share price. As **Mackintosh explained**, "share prices are arbitrary, as they depend on how many shares are issued; some companies have very high prices, which give them more influence on the Dow, even though they may be less valuable overall."
- **Market-cap weighting** is the most common weighting used by the most familiar indexes around the globe. It factors in outstanding shares as well as current share price to give more weight to the bigger players and less to the smaller fry.
- Some indexes are **equal-weighted**, giving each holding, large or small, equal importance in the final tally. For example, there's an equal-weighted version of the S&P 500, in which each company is weighted at 0.2% of the index total, rebalanced quarterly.

Indexes using different weightings can reach different conclusions about the performance of the same market slice.

Widely Inclusive or Highly Representative?

How many individual securities does an index need to track to correctly reflect its target market?

- The Dow uses 30 securities to represent thousands of publicly traded U.S. stocks. A throw-back to simpler times, it's unlikely you'll see other popular indexes built on such modest samples.
- On the other hand, the **Wilshire 5000 Total Market Index** "contains all U.S.-headquartered equity securities with readily available price data."
- The S&P 500 falls in between, tracking around 500 publicly traded U.S. securities.

Tracking a Narrow Slice or Mixed Bag?

If an index is tracking the U.S. market, should that include real estate companies too? If it's tracking bonds, are they corporate and municipal bonds, or just one or the other? Is an index broadly covering diverse sectors — such as representative industries or regions? How well do you know what your index is up to? How might each index's idiosyncrasies be influencing the accuracy of its outcomes?

One can conclude that some indexes are easier to translate into investable index funds than others. Some lend themselves better than others to a sound, evidence-based investment strategy. In our next and final segment, we'll explore the strengths and weaknesses inherent to index investing.

Until next time, no regrets!



Eric Hutchens
Chief Investment Officer

2022 Headlines

- Allodium was thrilled to host Kate McBride and Allan Henriques as featured speakers at a recent Allodium webinar called *15 Ways to Enhance Donor Trust by Improving Your Investment Stewardship* on April 21.
- David Bromelkamp taught a course at Lorman Education Services entitled *Using Investment Policy Statements as an Investment Tool: It's an Art, Not a Science* on May 24.
- Eric Hutchens passed Level II of the Chartered Financial Analyst® (CFA) Program.
- Saul Baumann attended the 2022 AQR conference in Chicago where he learned about advancements and the latest research on evidence based alternative investments.
- Our office will be closed June 20 and July 4 for company holidays.

Note: To find out more about Allodium's breaking news, please visit our website: www.allodium.com.

UPCOMING EVENT: JUNE 7, 2022

2022 Spring Wealth Management Webinar

Do current world events and recent market volatility have you concerned about your investments?

Join guest speaker Apollo Lupescu of Dimensional Fund Advisors for an Allodium webinar entitled *Navigating Turbulent Markets*. You will have a chance to ask questions.

June 7, 2022, at 3:00-4:00 p.m.

Webinar Registration Login:
tinyurl.com/2s382tdy



Apollo Lupescu
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FINANCIAL PLANNING TIP

How to Help the Next Generation

A few years ago, a global survey of bankers and advisors revealed that succession and inheritance issues were the top concerns among the ultra-wealthy. When asked why, 62% of respondents said they didn't feel their children would be encouraged to make their own wealth, while almost half said their children wouldn't know how to handle the investments.¹

Helping Children Learn How to Handle Investments

Wealthy parents worry their children will not be motivated to work hard in life. When kids are given too much too soon, it can take away their drive to achieve and be productive. Providing too much also sets up a co-dependency with the parents—the source of the money—which leads to other family and personal issues. A wealthy individual said to me, "you don't want your children to go into life expecting a lifestyle they just aren't capable of providing for themselves."

One way to encourage kids to become productive is to set up children's trusts with phased distributions based on specific criteria such as age, attaining an advanced degree, or earning their own money for some years. Independence gives adult children a chance to learn what it takes to succeed and build confidence and self-esteem. Using a trust may be a better option than an allowance because the trust has distribution rules that can't be changed or influenced by emotional arguments from children wanting more money.

Many wealthy parents believe it is inappropriate to discuss their finances with their children, so they simply don't. That makes sense when the kids are younger. As kids become mature adults, it is good to educate them on handling money and investments, so they are prepared and don't become overwhelmed when they receive their inheritance eventually. Adults with no practical money management experience may end up making poor financial decisions.

Ways Advisors Can Help Educate Future Heirs

Advisors can assist in providing financial education for adult children. The adult children can begin attending financial review meetings with their parents. Being in the meeting helps them learn about their parents' investment philosophy and approach to investing, along with learning about different types of investments, asset classes, etc. It provides an opportunity for the children to develop a relationship with the parents' advisors. They may feel more comfortable asking the advisors questions than their parents.

Carving off an "investment bucket," a smaller portfolio for them to oversee, is another way to help adult children learn. This can be a philanthropic fund like a donor-advised fund, or a taxable investment portfolio, which has taxes as an additional learning opportunity. It is often helpful for the parents to provide a mission or purpose for the portfolio through an investment policy statement.

Holding family meetings with advisors serving as facilitators is another way to help educate adult children. The advisors can be from the professional team supporting the parents, including the investment manager, financial planner, accountant, and estate planning attorney. The presence of advisors provides the formality and structure families may need for sensitive discussions about their finances and legacy wishes. The advisors can explain the family's overall wealth, the goals of the various investments, the investment results and answer questions. The presence of professionals helps the children understand that managing the family money is serious business. Let your advisor know how they can help educate your children.

1. *Wealth-X Presents: The Top Concerns of the Ultra Wealthy*. (March 17, 2016). Wealth X. <https://www.wealthx.com/featured/2016/top-concerns-ultra-wealthy/>

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