

Different Animals: Stock Averages and The Average Stock

Market indexes distort investors' perceptions

for most investors, the market averages have become illusions, creating a misinterpretation of market levels

and trends that often don't square with reality. In fact, this distorted perception among investors might be reinforcing and exaggerating the already-extended upward trend, spurring a feeding frenzy of historic proportions. Market averages and the average stock are definitely not the same thing.

According to a recent study by John Manley Jr., an equity strategist at Salomon Smith Barney, as of June 2, the average Nasdaq Composite stock had fallen 30% from its 52-week high; 60% of all Nasdaq Composite stocks were down 20% or more, and 84% were off more than 10%. Investors in larger stocks did better but still suffered; the average decline for an S&P 500 stock was 15%. But more than 10% of the stocks in that index were down 30% or more from their highs, and more than half had fallen at least 10%.

How can an index such as the Nasdaq Composite report a gain of 24% and yet the average stock in the index be down 30%?

The message fostered by indexes is that our equities markets are efficient and homogenized mechanisms with large groups of stocks that move in concert with each other. The reality is more random and complex. Look beyond the popular indexes, and you'll find that when one stock group benefits from market-

place events, others are hurt. The same goes for a weaker or stronger dollar, weather patterns, tax changes, consumer preferences, fads, and a litany of other influential factors. In short, on days when the popular indexes indicate that the market is up or down, a lot of other things are happening as well, and perhaps no discernible general trend can be found.

The problem with popular indexes is the confusion created by the unquestioned preservation of reporting methods of earlier and much smaller markets. Most investors believe the Dow Jones Industrial Average represents an investment portfolio of 30 big companies, measuring the periodic changes as if one owned these particular stocks over time. Investors view other indexes similarly, believing they represent real-world events. This is simply not true.

The real issue is *weight*, not price. A \$100 stock will influence the index four times more than a \$25 stock. This gives larger stocks a disproportionate influence that skews market averages.

Since investors think in terms of portfolio values, not relative stock prices, they tend to invest equally among the stocks in their portfolio rather than varying the amount according to the relative stock prices. In the real world, portfolios are weighted only by the amount of money in each stock and aren't affected by the high price of one stock vs. the low price of

another or by the overall capitalization of any given company. The only thing that counts is the amount invested.

As an illustration, consider the performance of a simple three-stock index over a one-year period, computed on a price-weighted basis like the Dow industrials (see chart).

In our example, the actual portfolio value didn't change, though the index was up 30%. This is because the 50% move in the higher-priced stock counts for more than the 50% decline in the lower-priced stock. The average gain in the three stocks was unchanged, but the stock average rose dramatically.

So rather than report a misleading index, perhaps it would be better to report no index at all. ☹



By John
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Sample Index

	Start Price	One Year	Start Amount	End Amount
Stock A	\$ 100	\$ 150	\$ 1,000	\$ 1,500
Stock B	\$ 40	\$ 40	\$ 1,000	\$ 1,000
Stock C	\$ 10	\$ 5	\$ 1,000	\$ 500
Starting Portfolio	\$ 150	\$ 195	\$ 3,000	\$ 3,000
Average	\$ 50	\$ 65		Up 30%

Source: Summit Global Management

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