THE Wealth REPORT

Market indexes track the performance of select groups of stocks, bonds or other investments that represent a particular facet of the market, such as government bonds, tech stocks or even the overall equity market.

A PRIMER ON MARKET INDEXES

Overview

In 1993, the Securities and Exchange Commission (SEC) adopted a new rule requiring every open-end management investment company, the entities that manage mutual funds and exchange-traded funds (ETFs), to provide an annual discussion of market factors, industry trends and management tactics that materially affect the fund's performance each year. Moreover, it required that each fund publish a line graph that compares the fund to an appropriate broad-based securities market index as a benchmark for performance measurement. The graph would assume a $10,000 hypothetical investment and reflect all fund expenses, sales commissions and account fees.[1]

A market index is a pool of securities that, in combination, represent a particular sector of the investment market. No one can invest directly in a market index; it is a hypothetical portfolio designed to measure the value of a market segment based on the performance of its underlying securities. In some cases, the value of the index is determined by assigning each security a weight in terms of how much it contributes to the overall worth of the portfolio. Assigned weights differ among indexes but may be determined by market capitalization, revenue, floating-rate or real market prices.[2]

Benchmarks

Even before the SEC ruling, market indexes were used to gauge the path and performance of specific market segments in fund sales and marketing materials. Post implementation, however, indexes became a predominant means for measuring overall price movements in the securities markets. Although you cannot invest directly in an index, they are used as the basis for a parallel portfolio managed passively to directly copy the movements and composition via an index fund. Because index funds are not actively managed, they tend to have lower fees. The first index fund was introduced for individual investors back in 1976 by John Bogle, founder of Vanguard Mutual Funds.[3]

Index = Diversification

Because each index comprises a diverse set of securities, mutual funds and ETFs of similar composition, they also tend to be inherently diversified. Be aware, however, that there are non-diversified funds that may have a smaller number of holdings — although by law no fund can feature holdings with more than 5% of its value in a single company's stock. Non-diversified funds generally focus on a single industry or geographic sector and are not characterized by the inherent diversification of a market index.[4] Investment diversification can be a key strategy because it is able to tap performance of rising stock prices to help counterbalance any declining share prices within the portfolio, thus helping to mitigate overall volatility.

Equity Indexes

There are approximately 5,000 indexes in the U.S. equity market. The Wilshire 5000 is composed of all publicly traded companies with headquarters in the United States with publicly available price data. However, it is not the most broadly cited index due to its size and span of holdings. Rather, the three most widely followed and quoted indexes are:[5]

1. DJIA — The oldest and best-known index in the world, the Dow Jones Industrial Average is composed of 30 of the largest capitalized (large cap) and most dominant (blue-chip) companies in the United States. It is a price-weighted index, meaning that higher-priced stocks have a greater influence on the portfolio's overall return. The DJIA accounts for about 25% of the entire U.S. stock market's value and is well represented by high-dividend paying companies.

2. S&P 500 — The Standard & Poor's 500 Index is made up of 500 of the top companies in the United States. It represents about 80% of the total U.S. stock market's worth and is market-weighted so that every stock is represented in proportion to its total market capitalization. The S&P 500 is widely considered a solid indicator of activity in the American markets.

3. Nasdaq — The Nasdaq Composite is a market-capitalization-weighted index. While it is known for being heavily represented by technology companies, it also includes securities from other industries (e.g., financials, industrials, insurance and transportation) and even companies not based in the United States. However, due to its tech tilt, it is considered a viable measure of tech industry performance, including speculative holdings with small market capitalizations.

"An index is not an investment in and of itself. It's a measure of performance for a certain set of securities. It's a sampling. Index funds will invest in the same securities as the underlying benchmark index."[6]

Bond Indexes

Likewise, the bond market also has benchmark indexes. Bond sectors are differentiated by issuer, so indexes are segmented by government, municipal and corporate bonds. Bond index values are measured by the change in market prices and interest payments associated with selected bonds over a specific term.

The U.S. Aggregate Bond Index (formerly known as the Lehman Brothers Aggregate Bond Index) is composed of a broad selection of U.S.-traded bonds and some foreign bonds that trade in the United States. Another prevalent index is the Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Brothers Aggregate Index), which is composed of individual bonds and bond funds.[7]

International Indexes[8]

The MSCI Indexes are widely recognized benchmarks that track performance of foreign securities. MSCI stands for "Morgan Stanley Capital Investments." Many MSCI indexes are widely used as benchmarks for foreign stock portfolio performance.

MSCI ACWI — This index represents the All Country World Index (ACWI), which covers more than 3,000 securities across a wide range of large-, mid- and small-cap stocks, as well as style and sector segments in 50 developed and emerging markets.

MSCI EAFE — This index represents Europe, Australasia and the Far East (EAFE). It is the predominant benchmark for the international market, aggregating 21 country indexes representing the world's major markets.

MSCI World — This index is comprises more than 1,600 securities from 23 developed countries, including the United States.

There are other well-known indexes that track various economies in Europe, such as the Financial Times Stock Exchange (FTSE) 100 in London, the Deutscher Aktien Index (DAX) in Germany, the Swiss Market Index in Switzerland and the Euronext 100 Index, a benchmark for European stocks.

Market Sector Indexes

Sector indexes represent stock holdings among industries for the sake of benchmarking performance. For example, an index may be defined by the maturity term of a pool of fixed income securities. An index may represent a geographic segment of the market such as emerging markets or stocks in the United Kingdom and Europe.

Within the S&P 500 Index, there are separate indexes that follow specific sectors:[9]

- S&P Communication Services Select Sector
- S&P Consumer Discretionary Select Sector
- S&P Consumer Staples Select Sector
- S&P Energy Select Sector
- S&P Financial Select Sector
- S&P Health Care Select Sector
- S&P Industrial Select Sector
- S&P Materials Select Sector
- S&P Real Estate Select Sector
- S&P Technology Select Sector
- S&P Utilities Select Sector

Market Factor Indexes

Sector indexes represent stock holdings that share a specific security characteristic or asset class, such as small cap value or dividend growth. Investors may choose to use market index funds to invest in emerging growth sectors or niches within certain sectors (e.g, renewables within the energy industry).

Final Thoughts[10]

Clearly, there are a lot of market indexes. They demonstrate how much expertise goes into tracking and benchmarking various investment opportunities. There are analysts who specialize exclusively in one area of the market and spend their days researching, interviewing and "kicking the tires" of companies included in that market segment. There is an awful lot of analysis that goes into determining whether a company's share price will rise or fall.

All of this information is aggregated via indexes to make it easier for brokers, advisors and investors to track and evaluate market movements. Indexes also make it convenient to build a portfolio with diversified exposure to a specific market of interest, using comparable benchmark values to gauge the investment's performance.

In fact, these days it's even easier to get diversified exposure to certain market segments via index-aligned mutual funds or ETFs. You can even combine them to create a strategic asset allocation designed to meet your long-term goals.

The point is, there is a lot of variance in index investment strategies for how to choose your investments. Choosing your investments goes beyond simply defining your financial goals, timeline and risk tolerance. Your financial professional can help you choose what segments of the market are best suited to meet your objectives and help you stay on track by comparing them to the indexes aligned with your investments.

[1] Securities and Exchange Commission. April 26, 1993. "Disclosure of Mutual Fund Performance and Portfolio Managers." https://www.sec.gov/rules/final/33-6988.pdf. Accessed March 29, 2022.

[2] Corporate Finance Institute. 2022. "Market Index." https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/market-index/. Accessed March 29, 2022.

[3] Eric Rosenberg. Investopedia. Dec. 21, 2021. "Best Solo 401(k) Companies." https://www.investopedia.com/best-solo-401k-companies-5089155. Accessed March 29, 2022.

[4] Christopher Raines. Zacks. 2022. "What Is the Difference Between a Diversified & Non-Diversified Mutual Fund?" https://finance.zacks.com/difference-between-diversified-nondiversified-mutual-fund-5139.html. Accessed March 29, 2022.

[5] Caroline Banton. Investopedia. Aug. 18, 2021. "An Introduction to U.S. Stock Market Indexes." https://www.investopedia.com/insights/introduction-to-stock-market-indices/. Accessed March 29, 2022.

[6,7,8] Kent Thune. The Balance. Jan. 26, 2022. "Major Market Indexes List." https://www.thebalance.com/major-market-indexes-list-2466397. Accessed March 29, 2022.

[9] Caroline Banton. Investopedia. Aug. 18, 2021. "An Introduction to U.S. Stock Market Indexes." https://www.investopedia.com/insights/introduction-to-stock-market-indices/. Accessed March 29, 2022.

[10] Julie Young. Investopedia. May 29, 2021. "What Is a Market Index?" https://www.investopedia.com/terms/m/marketindex.asp. Accessed March 29, 2022.

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