

# CITY SECURITIES WEALTH ADVISORS

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March 23, 2009

It has been a busy couple of weeks in our office, and I missed writing you last week. Today, the market is up over 4% in response to some good news regarding existing home sales and yet another attempt by the Treasury to provide liquidity for the toxic assets in our financial system. So far, we have seen the stock market rally 18% since the low on March 9th. If this rally continues much longer, we may see a shift in investor behavior - believing the recovery has arrived and beginning to invest in stocks with renewed enthusiasm - much earlier than I expected. As I wrote to you on February 2nd, we continue to anticipate the possibility of a strong but temporary market recovery during 2009. Whenever this occurs, we are continuing our strategy of taking advantage of market increases to shift assets into areas with the best prospects for growth while reducing portfolio risks.

A few letters ago, I mentioned that the S&P 500 is regarded as a much better representation of the U.S. stock market than the Dow Jones Industrial Average, and promised you an explanation in a future letter. This week, Ryan Veldhuizen, Financial Planning Associate and distinguished Orr Fellow in our office, has prepared a concise explanation of this reality that I believe you will find informative to your own understanding of the markets, and to how you interpret the market reports provided by the media.

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*Over the last few months, you may have noticed that the Dow Jones Industrial Average (DJIA or Dow) and the S&P 500 have not experienced similar daily percentage changes to the same degree they have historically. This has sparked renewed discussions in the financial community regarding the market representation of the oldest and most frequently referenced index – the Dow. Having been a staple of the U.S. financial markets since 1886, it is easy to see why the Dow is widely cited. It is nearly three times older than the 41-year-old S&P 500, the second most widely referenced index. And in an age when performing extensive calculations with a reasonable timeliness was not possible, the Dow's simple calculations served their purpose. However, a lot has changed since 1886. This is not to say that the Dow is meaningless; however, there are better indices available for gauging current market performance, and the S&P 500 is widely regarded as being a better representation of the U.S. stock market.*

*Why is the Dow not as good as an indicator of overall U.S. market performance? First, the Dow is made up of only 30 companies, as compared to the much broader S&P 500. Secondly, the Dow is a price-weighted index, while the S&P 500 is a capitalization-weighted index. In a price-weighted index, the value of the index is derived by adding up the price of each of the underlying stocks. So the effect of a \$10 stock is 1/10<sup>th</sup> that of a \$100 stock on the movement of the index. Whereas in a capitalization-weighted index, the effect each company has on the index is weighted according to the value of the company, not its stock price.*

*Using two stocks as an example of how this difference impacts returns, imagine an index consisting only of Google and Genentech – two U.S. companies with nearly identical market capitalizations (value), but with wildly different prices. Google closed on Friday, March 6th at \$308, while Genentech closed at \$90. In a capitalization-weighted index these two companies would have nearly identical weightings, but in a price-weighted index, Google's weighting would be over three times that of Genentech. Thus, these hypothetical indices would show a very different picture of the stock market that day, with the capitalization-weighted index up 6.1% versus the price-weighted index up only 3.5%.*

*Recently, this difference has become further exaggerated inside the Dow as several companies have suffered extreme price declines. Citigroup, GM, Bank of America, Alcoa, and GE are all currently priced at under \$10. Combined, these companies make up 1/6<sup>th</sup> of the companies in the Dow, but their combined weight in the index is 1/5<sup>th</sup> that of IBM alone, the most heavily weighted and highest priced company in the index. The result of these extremely low prices is that even if all 5 of these companies went out of business on the same day, the direct impact on the Dow would be less than -3%.*

*The flaws in the Dow as a measure of the U.S. stock market give us ample reason to switch our point of reference. But the Dow has been a fixture for so long that even within our office it has been difficult to shift away from it in our daily conversations about market movement. We don't expect the media or general public to change any time soon.*

*So, the next time you hear someone on the news talking about what the Dow did that day, just remember that the U.S. economy consists of more than just the 30 stocks in the Dow, and a properly diversified portfolio consists of asset classes that the Dow and S&P 500 miss entirely.*

*Ryan Veldhuizen*

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Later this week or early next week, I'll be sharing with you some thoughts on where the current economic downturn will ultimately take us. While there is still much uncertainty ahead, the future is very bright. I am eager to share with you some insights stemming from recent meetings and research at my office - there is reason for optimism about the future.

As a reminder, these client letters are also posted at [our company website](#). Please feel free to share them, and let me know of anyone I should include on this letter.

All the best,



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Vice President