Understanding Indices

In the financial arena, one of the most commonly asked questions when referring to the stock market, is “How is the market doing today?” As you might expect, individuals asking this question are interested in finding out how well, or how poorly, the market performed on that day. To get a general snapshot of the market, individuals can look at indices.

So what exactly is an index? An index is a statistical measure that represents the value of a group of stocks and is generally used to gauge stock market activity. It gives investors an indication as to how the basket of stocks it represents is performing. There are different ways of calculating an index number and it is important to understand how the index is calculated in terms of the weighting of stocks that it represents.

In a *price-weighted index* the weight of each stock is the stock’s price per share relative to the sum of all of the stock prices. Assuming that an index only has two stocks, one priced at $5 and one priced at $10, this index would comprise of approximately 33 per cent of the $5 stock and 67 per cent of the $10 stock. One disadvantage to price-based weighting occurs when a company issues a stock split because the weight of that company in the index changes even though there is no fundamental change in the company. As such not many indices are price-weighted.

A *market-value weighted index* tracks the proportion of a stock based on its market capitalization or “market cap”. Market capitalization measures a company’s size and is calculated by multiplying the company’s outstanding shares by the current stock price per share. If stock X has a market cap of $100 million and stock Y has a market cap of $30 million, assuming that there were no other stocks in the index calculation, in a market-weighted index, stock X would represent approximately 77 per cent of the value of the index. Weighting by market capitalization thus gives more importance to larger companies which consequently would have a greater impact or influence on the index.

In Trinidad and Tobago, there are two Indices: the Composite Index and the All T&T Index. The Composite Index collectively measures the price movements of all of the companies on the Trinidad & Tobago Stock Exchange and is calculated using the current aggregate market value as a per cent of a base aggregate market value which was established in January 1983.

The All T&T Index however, measures the price movements of listed companies that are registered in Trinidad & Tobago. To calculate the All T&T Index the market value of the non-sector companies and the market value of the cross-listed securities is deducted from the current aggregate market value. The end total is then expressed as a per cent of an All T&T base aggregate market value.

As an investor you also need to be mindful of what is going on internationally in the world markets that could potentially affect your portfolio. Some of the more widely followed international indices, each with their own advantages and disadvantages are noted below.

Dow Jones Industrial Average
The first stock market index ever created is the Dow Jones Industrial Average (DJIA), more commonly known as “The Dow”, back in 1896 by Mr. Charles Dow. At that time, the index covered only twelve stocks, however, today the Dow tracks the performance of thirty of the largest and most influential public companies in the United States. The Dow index is an example of a price-weighted index.

Standard & Poor’s 500 Index
The Standard & Poor’s 500 Index (S&P 500) tracks 500 of the most widely traded companies in the U.S. economy and for this reason it is considered a better indicator of overall market performance than the Dow, which only tracks thirty companies. While the S&P 500 is a more

reliable indicator of the market's overall status, one drawback is that the top 50 companies comprise 50 per cent of the index's value and hence have a greater influence on the index's price movement. The S&P 500 is a market-value weighted index.

Nasdaq Composite Index
The Nasdaq Composite Index covers all of the companies, more than 5,000 that trade on the Nasdaq stock market. While this index does encompass companies from a variety of industries, it mostly targets technology and internet-related stocks. As such, the Nasdaq is not intended to be representative of "the market" but is particularly beneficial to technology investors. The Nasdaq Composite is a market-cap weighted index and is different from the Nasdaq 100, which makes up 100 of the largest companies in the U.S. from the non-financial sector.

Russell 2000 Index
The Russell 2000 Index, created by the Frank Russell Company in 1972, measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which comprises of 3,000 of the largest U.S. stocks. The Russell 2000 is important because it includes small-cap stocks not captured in the bigger indices.

FTSE-100 (United Kingdom)
The FTSE-100, usually referred to as the "footsie", includes the top 100 public companies in the United Kingdom. This index is a market-value weighted index.

Nikkei (Japan)
The Nikkei, short for Japan's Nikkei 225 Stock Average, is a price-weighted index and is the most respected index of Japanese stocks. The Nikkei includes the top 225 blue-chip companies on the Tokyo Stock Exchange and is even considered to be Japan's version of the Dow.

Index Investing
Now that we've looked at what an index is and at some of the major types of indices, this information can be used to compare or benchmark the performance of your portfolio with the rest of the market. Indices are also a great tool for showing trends and changes in investment patterns. Furthermore, while it might not be cost effective to invest in, say, fifty stocks, you can "invest in indices" through various means such as index funds and exchange traded funds. These investment vehicles will give you the opportunity to build a portfolio that emulates a specific index.

Index funds are a type of mutual fund with a selection of stocks created to track the performance of a market index, such as the S&P 500 Index. Because investing in an index fund is a passive form of investing, this type of investment has a lower management expense ratio compared to that of a traditional mutual fund. There are many index fund companies offering several index funds that track the major indices as well as international index funds and bond index funds.

An Exchange Traded Fund (ETF) bears similar characteristics to a mutual fund but it can be traded like a stock on a stock exchange. Like an index fund, an ETF reflects a basket of stocks that mirrors a particular index but it can be traded like any other individual stock and thus can be bought or sold on a stock exchange at any time. For this reason, ETFs offer an investor the diversification of mutual funds along with the flexibility associated with stocks. Another reason that ETFs are attractive to an investor is that they are also passively managed, thus eliminating the fees charged by actively managed mutual funds. ETFs, however, do still incur commission charges, as with any other trade, by your broker.

While index funds and ETFs do not exist in Trinidad, they are available internationally and investors interested in these financial instruments should contact their financial advisor for further information.

The goal of any investor at the end of the day is to make their money work for them. In other words, to gain the most out of every invested dollar. While index investing won't guarantee that you will never lose any money, the beauty of index investing, whether through index funds or ETFs, is that it offers greater diversification to your investment portfolio as well as increased returns due to reduced operating expenses.

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