



PRATO CAPITAL

GETTING TO THE POINT OF A POINT

APRIL 2019

A quick online search for “Dow rallies 500 points” yields a cascade of news stories with similar titles, as does a similar search for “Dow drops 500 points.”

These types of headlines may make little sense to some investors, given that a “point” for the Dow and what it means to an individual’s portfolio can be unclear. The potential for misunderstanding also exists among experienced market participants, given that index levels have risen over time and potential emotional anchors, such as a 500-point move, do not have the same impact on performance as they used to. With this in mind, we examine what a point move in the Dow means and the impact it may have on an investment portfolio.

IMPACT OF INDEX CONSTRUCTION

The Dow Jones Industrial Average was first calculated in 1896 and currently consists of 30 large cap US stocks. The Dow is a price-weighted index, which is different than more common market capitalization-weighted indices.¹

An example may help put this difference in weighting methodology in perspective. Consider two companies that have a total market capitalization of \$1,000. Company A has 1,000 shares outstanding that trade at \$1 each, and Company B has 100 shares outstanding that trade at \$10 each. In a market capitalization-weighted index, both companies would have the same weight since their total market caps are the same. However, in a price-weighted index, Company B would have a larger weight due to its higher stock price. This means that changes in Company B’s stock would be more impactful to a price-weighted index than they would be to a market cap-weighted index.

The relative advantages and disadvantages of these methodologies are interesting topics themselves, but the main purpose of discussing the differences in this context is to point out that design choices can have

¹ Market capitalization is the product of price and shares outstanding.

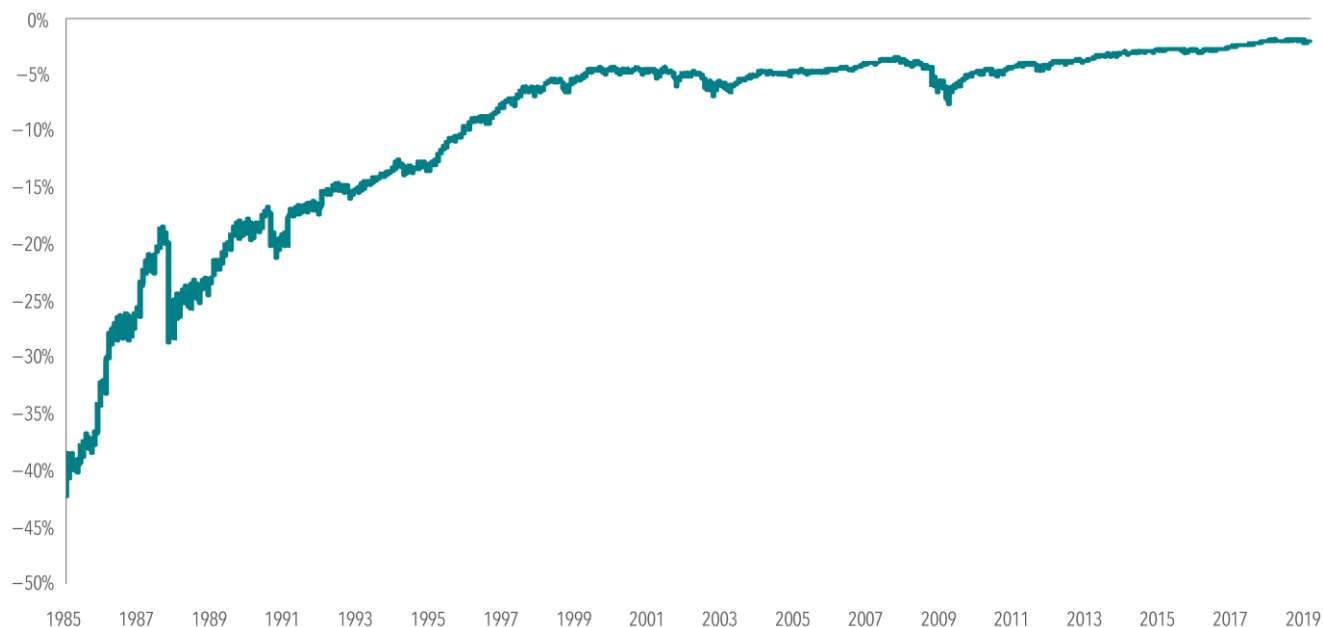
an impact on index performance. Investors should be aware of this impact when comparing their own portfolios' performance to that of an index.

HEADLINES VS. REALITY

Movements in the Dow are often communicated in units known as points, which signify the change in the index level. Investors should be cautious when interpreting headlines that reference point movements, as a move of, say, 500 points in either direction is less meaningful now than in the past largely because the overall index level is much higher today than it was many years ago.

Exhibit 1 plots what a decline of this magnitude has meant in percentage terms over time. A 500-point drop in January 1985, when the Dow was near 1,300, equated to a nearly 39% loss. A 500-point drop in December 2003, when the Dow was near 10,000, meant a much smaller 5% decline in value. And a 500-point drop in early December 2018, when the Dow hovered near 25,000, resulted in a 2% loss.

Exhibit 1. Hypothetical 500-Point Decline of the Dow Measured in Percentage Terms



Dow Jones and S&P 500 data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. The chart illustrates what a 500-point drop would have been in percentage terms for the Dow Jones Industrial Average on a daily basis. It assumes a 500-point loss took place each trading day from January 1, 1985, to February 1, 2019, and uses daily historical closing values of the Dow Jones Industrial Average to compute the percentage change. Percentage change does not indicate the actual change in the Dow during the period shown. Actual results may vary.

HOW DOES THE DOW RELATE TO YOUR PORTFOLIO?

While the Dow and other indices are frequently interpreted as indicators of broader stock market performance, the stocks composing these indices may not be representative of your diversified portfolio at Prato Capital Management.

For context, the MSCI All Country World Investable Market Index (MSCI ACWI IMI) covers just over 8,700 large, mid, and small cap stocks in 23 developed and 24 emerging markets countries with a combined market cap of more than \$50 trillion. The S&P 500 includes 505 large cap US stocks with approximately

\$23.8 trillion in combined market cap.² The Dow is a collection of 30 large cap US stocks with a combined market cap of approximately \$6.8 trillion.³

Even though the MSCI ACWI IMI, S&P 500, and Dow are all stock market indices, each one tracks different segments of the global stock market, so their performance can differ significantly over time, as shown in **Exhibit 2**. Since 1995, the Dow has outperformed the S&P 500 and MSCI ACWI IMI by an average of 0.5% and 3.3%, respectively (based on calendar year returns). However, relative performance in individual years can be much different. For example, in 1997, the Dow underperformed the S&P 500 by 8.4% but outperformed the MSCI ACWI IMI by 13.9%.

Exhibit 2. Performance of MSCI ACWI IMI, S&P 500, and Dow by Calendar Year

	1995	1996	1997	1998	1999	2000	2001	2002
DOW	37.6%	29.1%	33.4%	28.6%	30.7%	-4.9%	-5.5%	-15.2%
S&P 500	36.8%	23.0%	25.0%	18.1%	27.2%	-9.1%	-11.9%	-17.6%
MSCI ACWI IMI	17.2%	11.4%	11.1%	17.8%	21.0%	-15.4%	-15.6%	-22.1%
	2003	2004	2005	2006	2007	2008	2009	2010
DOW	35.5%	16.4%	11.5%	20.9%	11.2%	-31.9%	36.4%	15.1%
S&P 500	28.7%	10.9%	4.9%	19.1%	8.9%	-37.0%	26.5%	14.3%
MSCI ACWI IMI	28.3%	5.3%	1.7%	15.8%	5.5%	-42.3%	22.7%	14.1%
	2011	2012	2013	2014	2015	2016	2017	2018
DOW	8.4%	16.4%	32.4%	13.7%	1.4%	16.5%	28.1%	-3.5%
S&P 500	2.1%	16.0%	29.7%	10.0%	0.2%	12.0%	23.9%	-4.4%
MSCI ACWI IMI	-7.9%	10.2%	23.6%	3.8%	-2.2%	8.4%	21.8%	-10.1%

Dow Jones and S&P 500 data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. MSCI data © MSCI 2019, all rights reserved. MSCI ACWI IMI is the MSCI All Country World Investable Market Index (net dividends). Their performance does not reflect fees and expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

At Prato Capital Management, we believe a diversified portfolio will contain more than just the 30 stocks in the Dow. Depending on your needs and risk tolerance, a diversified portfolio may include a mix of global stocks, bonds, real estate, and any number of other assets not represented in a particular stock index. Although the news headlines about gains or losses in the Dow may be informative for one day, our focus for your portfolio is much longer-term and a one-day news cycle does not show returns over a 5-, 10- or 20-year period.

CONCLUSION

News headlines are often written to grab attention. A headline publicizing a 500-point move in the Dow may trigger an emotional response and, depending on the direction, sound either exciting or ominous enough to warrant reading the article. However, after digging further, we can see that the insights such headlines offer may be limited. At Prato Capital Management, we are focused on tuning out the noise and focused on the long-term results of a diversified portfolio matched to the needs of your Financial Life Plan.

² 500 companies are included in the S&P 500 Index. However, because some of these companies have multiple classes of stock that meet the requirements for inclusion, the total number of stocks tracked by the index is 505.

³ Market cap data as of January 31, 2019.