Introduction to Indexes

How many times have you heard someone ask, "How'd the market do today?" But what is "The Market?" And how do we know how it did? Usually, the answer reflects the performance of an index, rather than the market as a whole.

Back in 1896, Charles Dow created a benchmark of 12 large U.S. companies to serve as an indicator of how well stocks in general performed each day. That was the first broad-market index and it is still the one that is most often used to answer the question, "How'd the market do today?" In the years since 1896, the Dow Jones Industrial Average (DJIA) has been expanded to include 30 top U.S. companies, and many other indexes have been devised. Still, the Dow remains the most influential stock index in the world.

But the Dow cannot be all things to all people. A broader stock market index, the S&P 500, is also quoted often. As you might guess, the S&P 500 is a listing of 500 of the largest market cap companies traded on U.S. exchanges. It was created and is maintained by Standard and Poor's Index Services along with the S&P 400 (400 top mid-sized companies), the S&P 600 (top 600 small companies) and a couple dozen international and global indexes.

What all indexes have in common is that the value of the index changes proportionally to the value of the stocks in the index. So when the index goes up, the aggregate value of the stocks on the index has grown by a proportional amount, and vice versa.

Other organizations have created their own list of companies that measure "the market" or a particular subset of the market. There are indexes that track every publicly traded stock (the Wilshire 5000), the top 100 stocks traded on the Nasdaq exchange (the Nasdaq 100), biotech stocks, utility stocks, pet superstore stocks, and stocks that start with J. (Kidding about those last two, but check back next year. Indexes are a booming business.)

The best thing about indexes is that you can invest in them. Instead of investing in a mutual fund that pays some Harvard MBA stock picker a salary slightly larger than the GDP of some third-world countries, index investments simply buy the stocks that make up a particular index. Voila! Instant fund sans the human element. And that's a good thing.

Investment returns for index funds will closely match the performance of the index as long as expenses are low. This is good news for investors who may be tired of paying that Harvard grad to underperform the market, as about 80% of managed mutual funds do. Index investing is perfect for novice investors who just want the benefits of stock ownership without either the hassle or the risks that are inherent in picking your own stocks.

Before you start putting money in an index, however, take the time to look at a few of the major broad-market indicators to get a better feel for just what an index measures. We've gathered some basic facts and figures to help you get a feel for each:

- Top-weighted companies
- Industry composition
- Performance over 1- and 3-year periods
- Strengths and weaknesses

One final point: Even if you don't invest in indexes, it is important for individual investors to select an appropriate index against which to compare the performance of their own portfolios. An investor who gains 7% per year in stocks could feel very good about that if comparing it to a bank account. But the fact that her returns trailed those of the Standard & Poor's 500 index for the same time period would paint this performance in a different light.